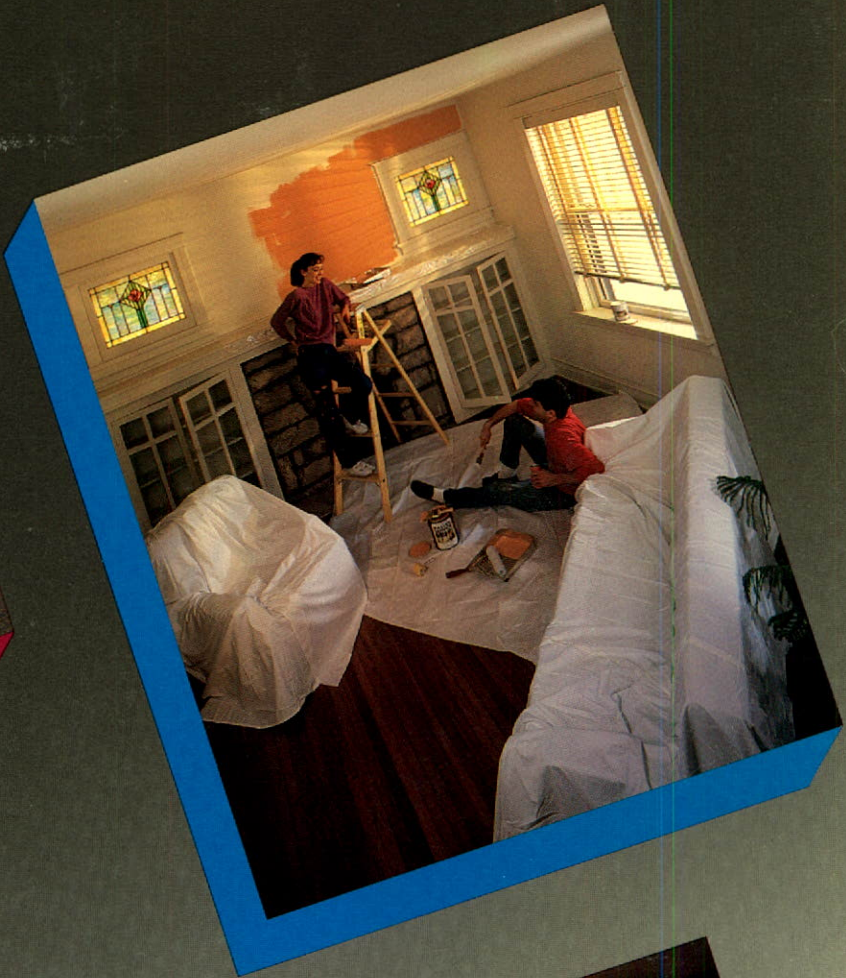
INTERCO

1986 ANNUAL REPORT



INTERCO Today

INTERCO is a broadly based major manufacturer and retailer of consumer products and services represented by four operating groups.

Apparel Manufacturing Group consists of 11 apparel companies operating 46 manufacturing plants and 12 major distribution centers across the country. The group designs, manufactures and distributes a full range of branded and private-label sportswear, casual apparel, outer garments and headwear for men and women. Distribution is national in scope to department stores, specialty shops and other retail units. Substantial distribution, under private and branded labels, is also made to large national retail and discount chains.

General Retail Merchandising Group operates 248 retail locations in 22 states offering to the consumer a large assortment of products and services. General retailing includes large do-it-yourself home-improvement centers, junior department stores, discount stores, men's specialty apparel shops, and specialty department stores. Seven modern regional distribution centers support these retail locations.

Footwear Manufacturing and Retailing Group operates 873 retail shoe stores and leased shoe departments in 43 states in this country, as well as in Australia, Canada and Mexico. The group also styles, manufactures and distributes primarily men's footwear in most major price ranges in the United States, Canada and Australia. There are 13 shoe manufacturing plants and three major distribution centers in operation.

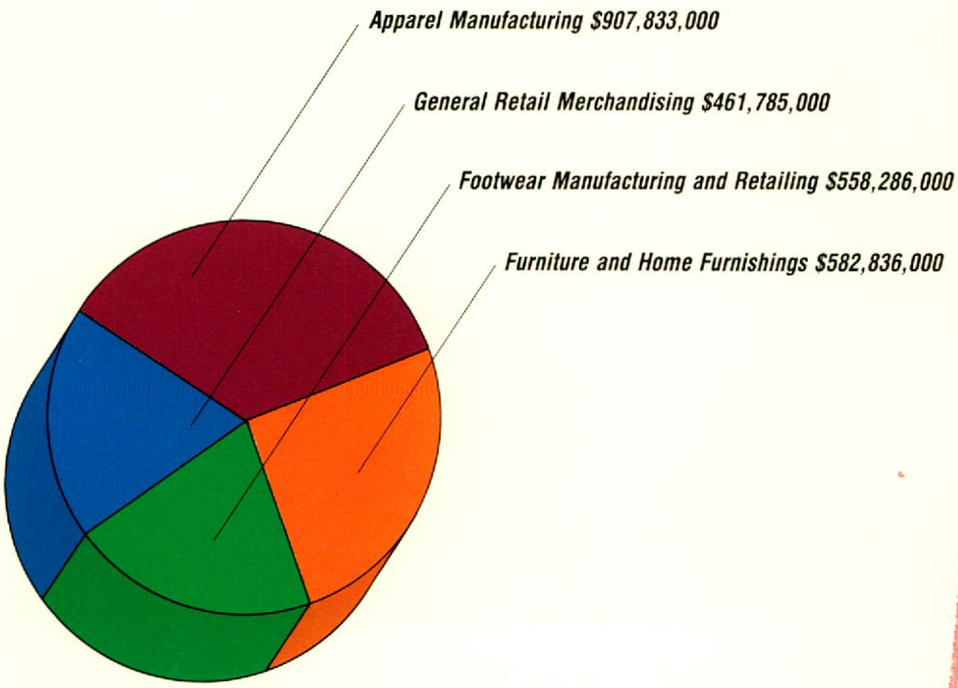
Furniture and Home Furnishings Group manufactures and distributes quality furniture and home furnishings. There are 46 factories and 12 major distribution centers and consolidation warehouses located throughout the United States. The company also owns and operates 16 galleries.

Contents

HIGHLIGHTS

Years Ended	February 28, 1986	February 28, 1985	Change
From operations:			
Net sales	**$2,510,740,000**	$2,625,746,000	(4.4)%
Net earnings before asset redeployment expenses	**92,347,000**	92,163,000	0.2 %
As a percent of sales	**3.7%**	3.5%	
Net earnings	**92,347,000**	72,163,000	28.0 %
As a percent of sales	**3.7%**	2.7%	
Per share of common stock:			
Net earnings before asset redeployment expenses	**$5.84**	$ 5.68	2.8 %
Asset redeployment expenses	**$ —**	$(1.23)	
Net earnings	**$5.84**	$ 4.45	31.2 %
Dividends	**$3.08**	$ 3.03	1.7 %
Financial condition at year end:			
Working capital	**$ 847,182,000**	$ 781,333,000	8.4 %
Current ratio	**4.7 to 1**	4.2 to 1	
Total assets	**1,563,840,000**	1,535,241,000	1.9 %
Shareholders' equity	**1,111,293,000**	1,064,764,000	4.4 %
Book value per common share	**$73.04**	$70.43	3.7 %
Shares outstanding at year end:			
Common	**14,310,228**	14,076,610	
Preferred	**660,273**	733,037	
Number of shareholders	**10,500**	11,500	
Number of employees	**46,000**	48,000	

CONTRIBUTION OF SALES BY OPERATING GROUP



To Our Shareholders

Results improved in the latter part of the year enabling full year's earnings to slightly exceed those of the prior year on a comparable basis. The leadership position enjoyed by so many of the INTERCO companies was responsible for this despite the difficult market conditions for many of our products and services.

Net sales were $2.51 billion compared with $2.63 billion reported in fiscal 1985, while net earnings of $92.3 million compared with $72.2 million, a year ago. Net earnings per share were $5.84 for the year, compared with last year's reported $4.45 per share.

After adjusting for the effect of the fiscal 1985 asset redeployment program, net sales were almost even for the year while net earnings were slightly ahead. Also, on a comparable basis, net earnings per share were $5.84 compared with the $5.68 per share earned in fiscal 1985 before the one-time charge of $1.23 per share.

We were pleased to show an earnings increase for the year on the basis of continuing operations. Cost-control efforts were instrumental in improving the after-tax profit margin to 3.7 percent of sales. Return on assets was also higher in 1986. While by no means at a level acceptable to management, return on shareholders' equity of 8.5 percent represented a better performance. Thus, your company made progress in terms of the fundamental corporate goals noted in last year's report to shareholders. These goals remain:

- increased return on corporate assets,
- long-term growth in sales and earnings, and
- improved return on shareholders' investment.

Although most of our products and services are market leaders, with strong consumer recognition, INTERCO's valuation in the financial marketplace frequently does not seem to be indicative of this position, or of the excellent management team within the company which makes such leadership possible. The business segments in which we operate are extremely competitive and it is the entrepreneurial management approach which preserves and fosters our market position.

Recognizing the near parity of the book value to market price of our shares which prevailed during the past year, the Board of Directors authorized an additional repurchase program in December 1985 of up to one million INTERCO common shares. This program follows the earlier repurchase of one million shares of common stock initiated in June of 1984. The treasury shares resulting from both programs may be used for general corporate purposes, including possible acquisitions. Acquiring shares at close to book value represents a good investment for your company as well as a means of increasing earnings per share and return on shareholders' investment.

INTERCO is one of the world's leading consumer-oriented companies. Our products and services are market leaders in their respective areas. We remain committed to these businesses and, more important, to expanding them in the years ahead. Although internal growth remains key to our corporate strategy, selective acquisitions in our existing areas of operations offer an important means of accelerating this growth. We continue to vigorously explore such opportunities. Management is also reviewing acquisition possibilities in the consumer products area which might add another major operating group to the INTERCO family. Key criteria in evaluating all acquisition opportunities include superior long-term growth potential, strong brand names, existing market leadership and a successful in-place management team.

Reviewing the results of our four operating groups during the past year, the Apparel Manufacturing segment was particularly impacted by the competitive environment. Our response was to improve product sourcing while introducing new competitively priced apparel distinct from our market-leading branded merchandise. This program will help to expand the market for our companies. While many new product introductions have

been well received, industry conditions, particularly in the women's group, continue to be characterized by intense competition, promotional pricing and some lack of fashion direction. The men's apparel companies did achieve improved performance over the prior year.

The General Retail Merchandising Group, which benefited from last year's asset redeployment program, showed significantly better operating earnings. Return on sales of 6.9 percent represented this group's best performance in seven years. This progress was achieved despite aggressive competition in the do-it-yourself home-improvement sector.

Our Footwear Manufacturing and Retailing Group's performance was impacted by highly promotional pricing and excessive inventories on the part of footwear retailers. Our strategy is to continue offering the consumer quality and value while maintaining market leadership with brands such as *Florsheim* and *Hy-Test*. Improved sourcing and stringent cost controls, coupled with innovative marketing programs supported these objectives during the past year.

The Furniture and Home Furnishings Group achieved both increased sales and operating earnings during 1986 with particular strength in the second half. The *Ethan Allen* and *Broyhill* names are recognized as providing outstanding quality and consumer value as more emphasis is placed on the home environment by multiple income families and single individuals. Demographic trends, together with the recent decline in interest rates and acceleration in new residential construction, give promise for continued growth of this business during the current and future years.

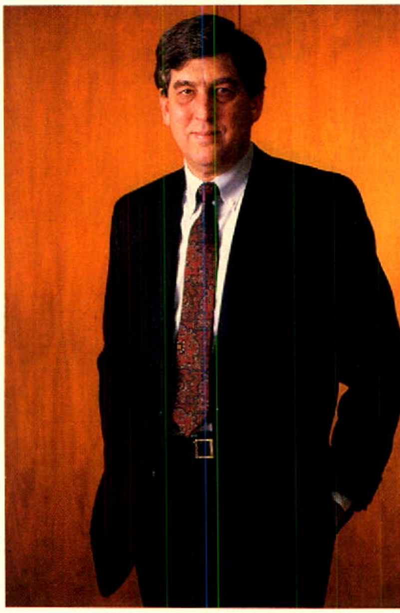
INTERCO's financial position and cash flow remain favorable, thus providing the ability to expand existing operations with internally generated funds. Capital expenditures projected for fiscal 1987 may slightly exceed the $45 million invested in 1986. Our working capital ratio was 4.7 to 1 at year end. We have the ability to readily finance acquisition opportunities as a result of a debt-to-capitalization ratio of 14.2 percent.

An active Board of Directors is of vital importance to the company. Your management values the guidance provided by the Board in the past and looks forward to their continued counsel in the future. We wish to acknowledge the retirement in June 1985 of John K. Riedy, former Chairman of the Board and Chief Executive Officer of INTERCO. Mr. Riedy was a career employee with more than 50 years of loyal dedicated service. Also, two members of the Board of Directors, who have made significant contributions to the company, are retiring and will not stand for re-election this year. Edwin S. Jones has served with distinction since 1970. We are very appreciative of his 16 years of service. Paul H. Broyhill retired as a Director and Vice President of INTERCO on December 31, 1985. Mr. Broyhill was instrumental in the growth of Broyhill Furniture Industries and provided the company with substantial insight into the furniture industry.

In June of last year, in addition to my being elected Chairman of the Board, Ronald L. Aylward was elected Vice Chairman of the Board and Harry M. Krogh, formerly President of the Florsheim Division, was elected President and Chief Operating Officer of INTERCO.

As we enter the new year, we are hopeful that an improved consumer spending environment and the continued decline in interest rates will allow us to benefit from the important strategic repositioning steps that have been taken. This year's Annual Report to Shareholders focuses on the markets served by INTERCO and its leadership as a major marketing company.

On behalf of INTERCO's management and Board of Directors, we are grateful for the continuing support of our customers, employees and shareholders during the past year.



Harvey Saligman
Chairman of the Board and
Chief Executive Officer

April 14, 1986

Management's Discussion and Analysis of Results of Operations and Financial Condition

Results of Operations

This discussion supplements the detailed information presented in the consolidated financial statements and footnotes which begin on page 26. In addition, reference should be made to the operations review on pages 8 through 23.

Asset Redeployment Program–On November 1, 1984, the company announced that it would accelerate its asset redeployment program under which certain operating divisions not meeting the long-term profitability requirements of the company would be sold or liquidated. To cover the estimated costs and expenses associated with the program, a pretax reserve of $35 million ($20 million after tax, or $1.23 per share) was provided in the third quarter ended November 30, 1984. Accordingly, the sales and earnings of the operating divisions involved in this program are not included in the results of operations subsequent to the second quarter of fiscal 1985.

Net Sales–Net sales for fiscal 1986 were $2.51 billion, a decrease of 4.4% from the $2.63 billion reported in fiscal 1985. Net sales for fiscal 1985 were $2.63 billion, a decrease of 2.0% from the $2.68 billion reported in fiscal 1984. The decrease in fiscal 1986 and fiscal 1985 was attributable, principally, to the asset redeployment program in the Apparel and General Retail Groups of the company. Excluding the effect of the asset redeployment program, sales for fiscal 1986 would have declined by 0.8% and sales for fiscal 1985 would have risen by 1.3%.

Other Income, Net–For fiscal 1986, other income increased by 1.2%. For fiscal 1985, other income decreased by 28.4% after rising by 49.4% in fiscal 1984. The increase for fiscal 1984 was due principally to increased interest income, gains on the sale of marketable securities, insurance settlements and net debt retirements.

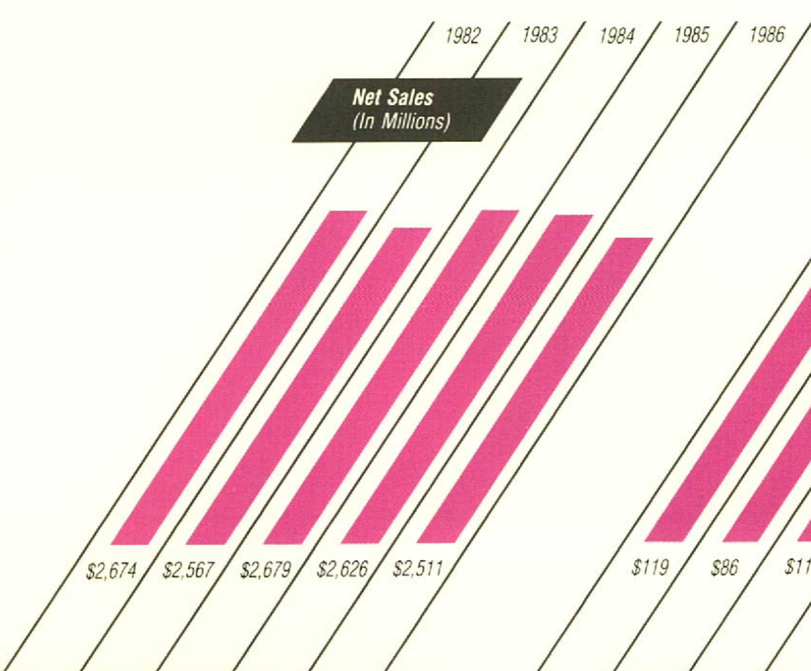
Gross Margins–Gross margins for fiscal 1986 were $785.4 million, or 31.3% of net sales, as compared to $811.8 million, or 30.9% and $858.5 million, or 32.0% for fiscal 1985 and 1984, respectively. The improvement in fiscal 1986 was principally attributable to higher gross margins in the General Retail Group when compared to fiscal 1985, and the benefit of cost reduction programs which included improved manufacturing equipment and techniques, changes in sourcing and the elimination of excess plant capacity. In fiscal 1985 margins were unfavorably affected by a higher level of promotions and discounting by retailers industry-wide, particularly in apparel and footwear products, shorter manufacturing runs which adversely affected production efficiencies and start-up costs associated with new product introductions.

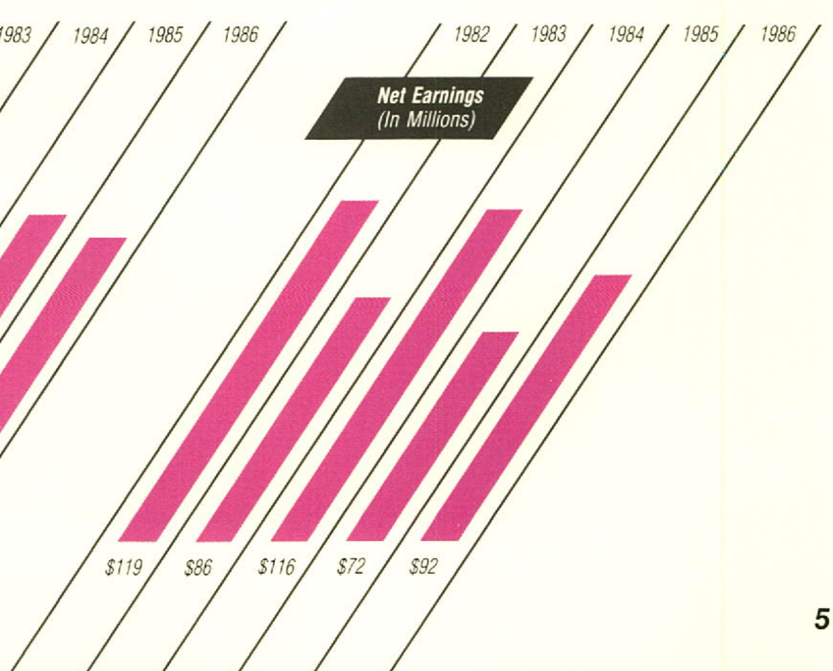
Selling, General and Administrative Expenses–Selling, general and administrative expenses were $613.2 million, $638.2 million and $650.3 million for fiscal 1986, 1985 and 1984, respectively. As a percent of sales, selling, general and administrative expenses were 24.4% for fiscal 1986, as compared to 24.3% for both fiscal 1985 and 1984. The dollar decreases each year reflect the effects of the asset redeployment program and the cost and expense reduction program of the company.

Interest Expense–Interest expense in fiscal 1986 amounted to $25.5 million compared to $26.4 million and $31.7 million in fiscal 1985 and 1984, respectively. The decline in fiscal 1986 and fiscal 1985 was attributable to a reduction in the level of long-term debt. The decline in fiscal 1984 was attributable to a reduced level of long-term borrowing and the elimination of any short-term domestic borrowing during the year.

Income Taxes–The effective tax rate for fiscal 1986 was 48.4% compared to 49.9% and 47.4% in fiscal 1985 and 1984, respectively. The increase in the effective rate for fiscal 1985 was attributable to certain nondeductible expenses associated with the asset redeployment program, and a higher effective state rate, whereas the fiscal 1986 and fiscal 1984 rates benefited favorably from certain capital gains.

Earnings Per Share–Earnings per share for fiscal 1986 were $5.84, an increase of 31.2% from the $4.45 in fiscal 1985 which reflected a 36.6% decrease from fiscal 1984. The earnings in fiscal 1985 were impacted by a charge of $1.23 per share to cover the estimated costs and expenses associated with the asset redeployment program. Excluding this charge, earnings per share increased by 2.8% from fiscal 1985. The increase in earnings per share in fiscal 1986 reflected the substantial improvement of the General Retail Group and increased results of the Furniture and Home Furnishings Group, particularly in the second half of the year. The average shares outstanding for the last three years decreased slightly and did not materially effect the earnings per share.



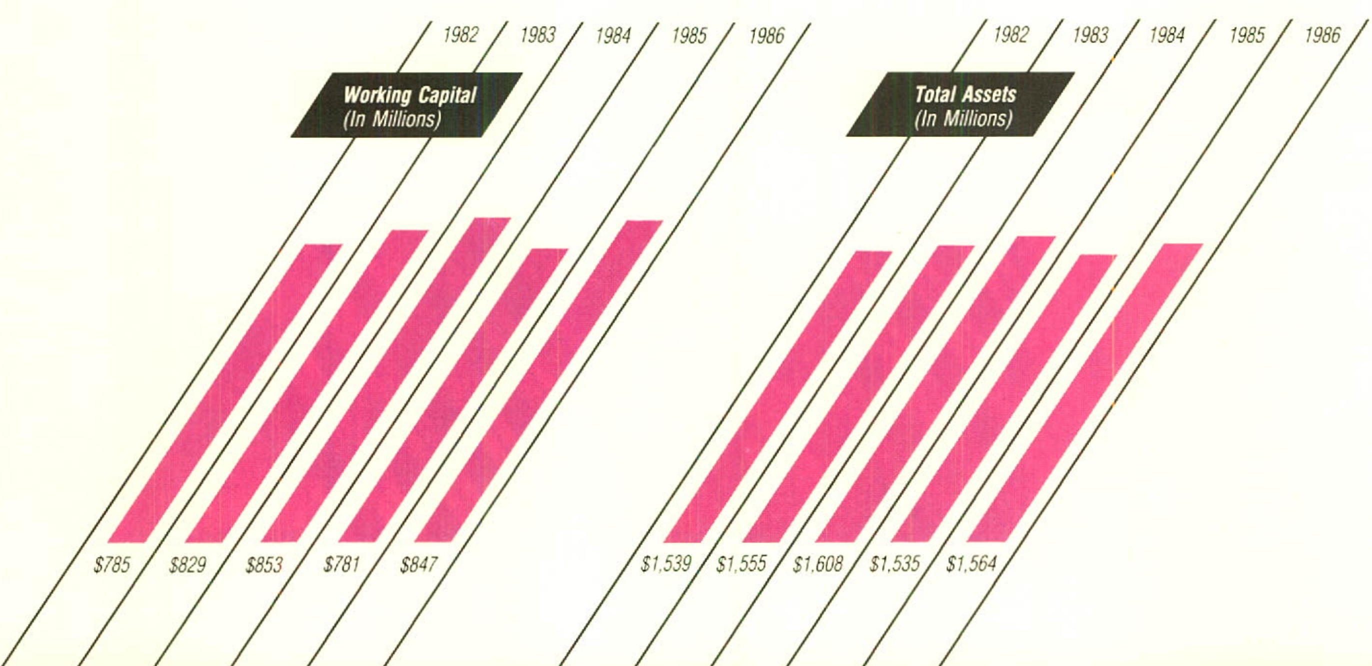


Management's Discussion and Analysis of Results of Operations and Financial Condition (Cont'd.)

Financial Condition

The company's financial position continues to be strong.

- Working capital, the excess of current assets over current liabilities, was $847.2 million at the end of fiscal 1986. The current ratio rose to 4.7 to 1 at February 28, 1986, from 4.2 to 1 the prior year.
- Cash and short-term investments totaled $110.3 million at year end, an increase of $64.8 million from the prior year. The cash generated during the year was after providing for normal debt retirements, net of debt additions; capital expenditures; and common stock repurchases.
- Accounts receivable were $333.6 million at February 28, 1986, a decrease of $1.7 million from the prior year. The decrease in the current year was achieved after a modest sales increase in the last quarter of the year, thus improving the receivable collection cycle.
- Inventories were $609.0 million, a decrease of $6.3 million from the prior year. During the year, the company continued its emphasis on improved inventory turnover. This program was successful and will be extended in fiscal 1987.
- Accounts payable and accrued expenses decreased $11.7 million, reflecting the lower level of inventories, and a reduction in accrued employee compensation.
- Long-term debt decreased by $5.9 million during the year after a decrease of $6.6 million in fiscal 1985, as a result of normal debt retirements, offset by certain new project financings. This followed a decrease of $53.4 in fiscal 1984 when the company exchanged 100,000 common shares plus $5.6 million in cash for $15.9 million face value of the 4⅝% promissory notes and purchased $25.0 million of 14¼% promissory notes for cash.



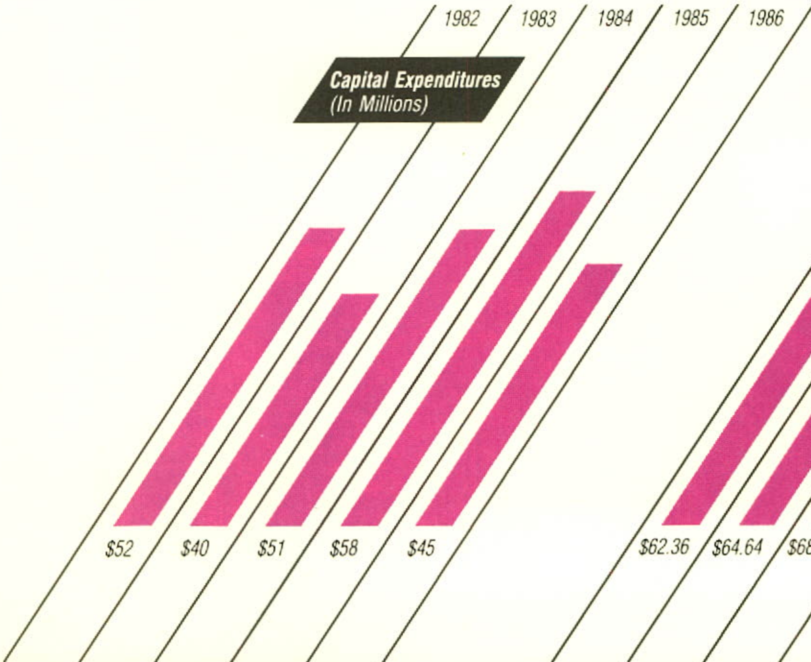
Financing Arrangements – At each fiscal year-end, the company had no short-term borrowings. To meet short-term working capital requirements, the company maintains a credit agreement enabling it to borrow up to $100 million in domestic or Euro-Dollar loans through February 28, 1987. Borrowings outstanding as of February 28, 1987 are repayable from that date through February 28, 1991. This credit facility is primarily intended to support commercial paper borrowings as required. The company also maintains other bank lines of credit as credit availability and additional support for the sale of commercial paper.

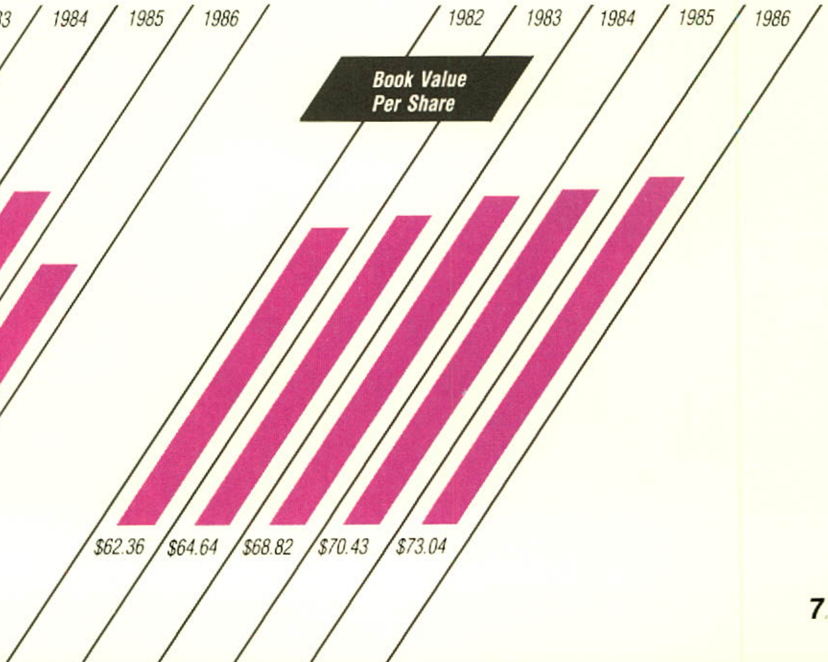
Capital Expenditures – The company maintains formalized procedures for the review of capital expenditures. These include return on investment and project payback analyses. Capital expenditures, for company-owned and capitalized leased property, aggregated $246.6 million during the last five years, of which $44.8 million occurred in fiscal 1986. Cash flow from operations provides the principal source of funds to support capital expenditures. For fiscal 1987, capital expenditures are forecast to be slightly above $45 million with depreciation also being somewhat higher than fiscal 1986.

Inflation Accounting – In Note 16 of the Notes to Consolidated Financial Statements, the company reports on Inflation Accounting based on the Consumer Price Index for all Urban Consumers as required by the Financial Accounting Standards Board.

Dividends – Fiscal 1986 was the 75th consecutive year of cash dividend payments. Cash dividends of $49.1 million were paid during the fiscal year, with $43.7 million to holders of common stock and the remainder to holders of preferred stock.

The quarterly dividend rate on common stock was $0.77 per common share, or an annual indicated rate of $3.08 per common share.



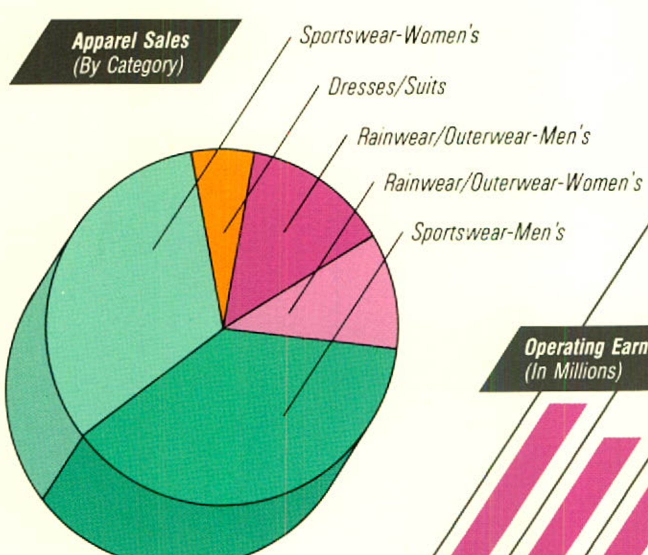


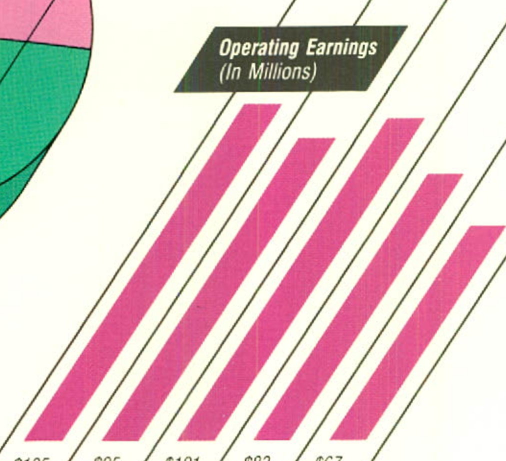
APPAREL MANUFACTURING

The markets for INTERCO's Apparel Manufacturing Group are by their nature subject to rapid changes in consumer taste, and the company's emphasis on entrepreneurial management facilitates flexibility in responding to fashion demands and remains an essential ingredient to INTERCO's continued leadership in these markets. This management philosophy enabled the Apparel Group to continue its market leadership during fiscal 1986, notwithstanding the weak consumer economy, the highly promotional and competitive environment, the lack of fashion direction, and the consolidation of departments and buying functions by major chains, all of which adversely impacted the apparel market during the past year.

Sales in fiscal 1986 totaled $907.8 million versus $943.1 million last year. Operating earnings (before corporate expenses, interest cost and income taxes) of $66.7 million compared with the $83.0 million earned in the prior year. The resultant return on sales was 7.3 percent versus 8.8 percent in fiscal 1985.

While the Apparel Group offers a broad price range of men's and women's apparel, the Group's overall market approach is characterized by its orientation to value. In providing such value and quality merchandise in their markets, the apparel companies have responded to competitive conditions by emphasizing aggressive cost-control programs. These programs include expanded offshore sourcing of products, improved manufacturing and distribution



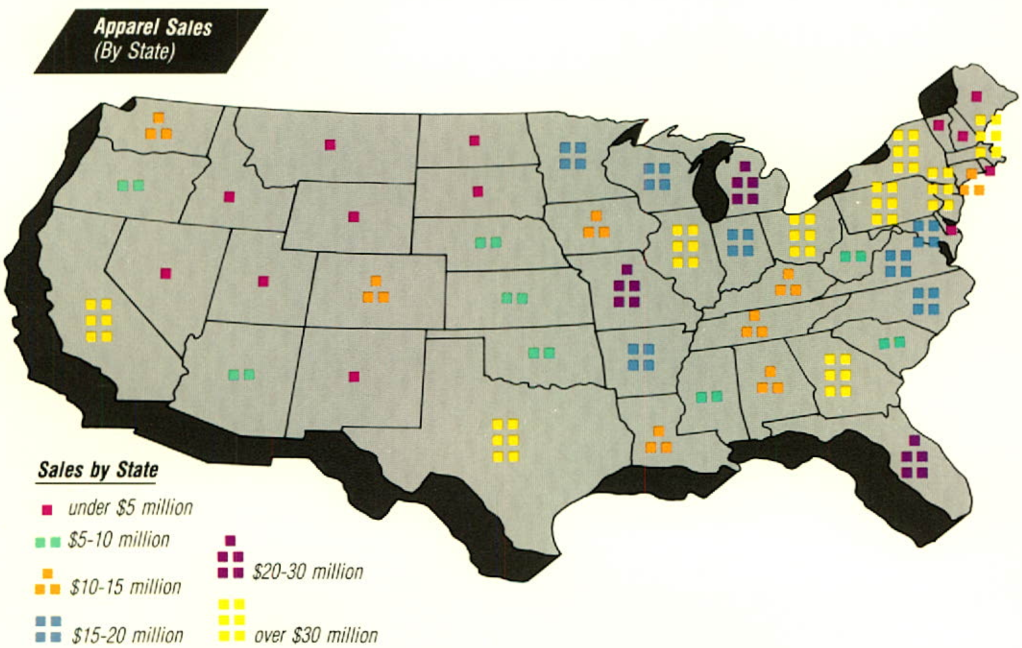


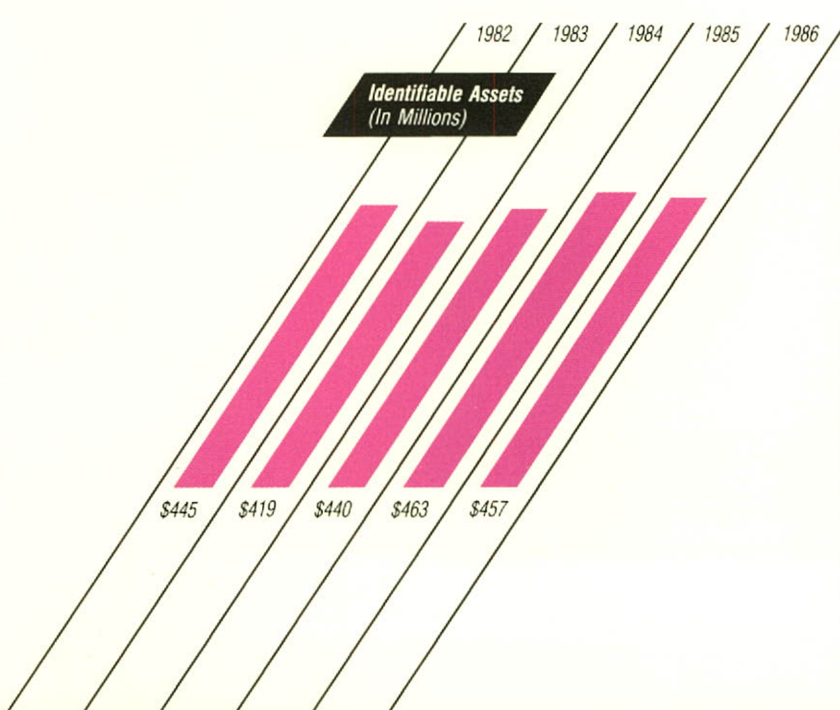
Major Apparel Brands for Men:

Allyn St. George
Big Yank
Campus
Campusport
Cherokee
Clipper Mist
Cowden
Cowden Genes
Donegal
J J Cochran
John Alexander
Le Tigré
London Fog
London Towne
Made On Earth
Maincoats
Outdoors Unlimited
Prince Bellini
Private Line
Rough Rider
Royal Castle
Rugged Country
Sportabouts
Startown
Tailor's Bench
Tempo Europa
Tour de France
Winning Edge
Work-Mates by Big Yank

techniques and increased use of computer-based management information systems in logistics planning. The combination of these programs and a vigorous new product effort will enable INTERCO to remain a leader in its markets.

The Group introduced a number of new products during the year, and additional product lines were developed and are currently being introduced. These include the *Cherokee* collection of men's leisure apparel by *Cowden,* and two new labels at *Campus, Made on Earth,* a line of young men's fashion sportswear to complement *Campus'* more traditional line of *Le Tigré* young men's clothing, and *J.J. Cochran,* targeted at the more mature men's sportswear market. Further, *Campus* has recently launched its Wilt Chamberlain collection of Big and Tall *LeTigré* merchandise.





Major Apparel Brands for Women:

Abe Schrader
Blake
Candie's
Casual Acquaintance Collection
C'est Petite
College-Town
Coppertone
Cowden
Cowden Genes
Devon
Givenchy
It's Pure Gould
John Alexander
Lady Devon
Le Tigré
Le Tigré, Jr.
London Fog
London Towne
Maincoats
Ms. Blake
Outdoors Unlimited
Pant-her
The Petite Concept
Queen Casuals
REJOICE!
Schrader Sport Dresses
Schrader Sport Separates
Smith & Jones
Smith & Jones For Her
Smith & Jones Petites
Stuffed Shirt
T. A. Whitney
Tour de France
Two Rivers
Winning Edge

INTERCO's *London Fog* rainwear, *Devon's T.A. Whitney* and other Apparel Manufacturing Group products appeal to today's career men and women who appreciate fashion, quality and value.

Apparel Manufacturing

Londontown, the leading producer of rainwear and outerwear, has recently announced its new prestige line of rainwear called *Tempo Europa*. This collection will focus upon advanced styling coupled with superior moisture resistance as a result of its use of new fabrics. The label is aimed at higher priced market segments.

International Hat signed a new licensing agreement for the manufacture and marketing of women's recreational headwear under the *Coppertone* label. A new line of women's felt headwear, with excellent rain-repellent characteristics, will be introduced under the *Clipper Mist* name during the current year. *Stuffed Shirt* has released its new *Candie's* collection of color-related separates, focusing on the junior sportswear consumer. This contemporary line was introduced in the fall of 1985 and initial market reception has been excellent.

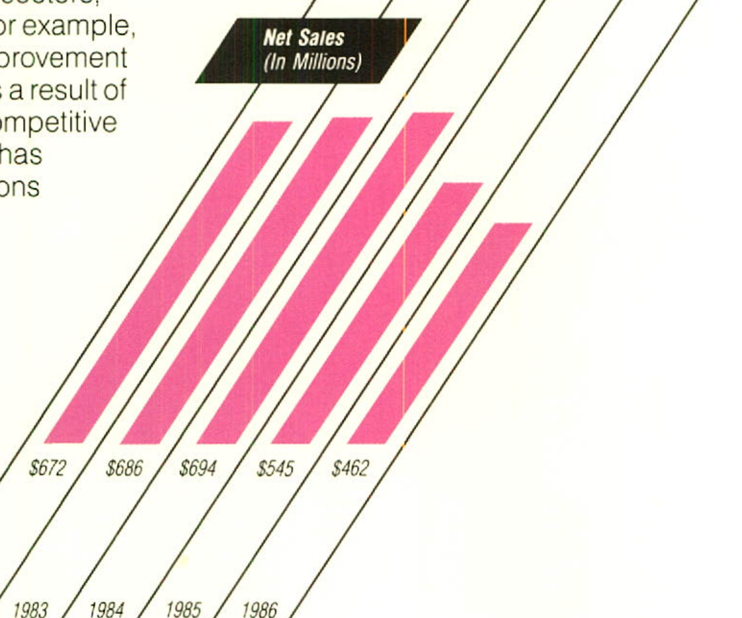
Devon introduced *T. A. Whitney,* a line of moderately priced updated coordinated separates, directed toward career-oriented women. It has been enthusiastically received and, as a result, is being aggressively marketed. Similarly, *Queen Casuals* successfully introduced a new line of related separates through its large-size division, *Smith & Jones for Her.* Indicative of INTERCO's response to fashion demands, this new product offering is targeted at the larger size woman who is an important customer for department and specialty stores. *Abe Schrader*'s direction to the upscale consumer is supported by a recent licensing agreement wherein *Abe Schrader* will produce and market coats, suits, dresses, separates and knits under the well-recognized *Givenchy* label.

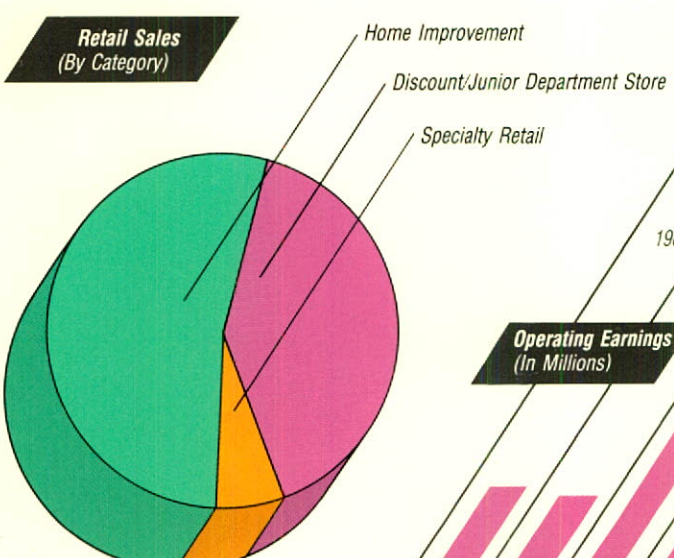
GENERAL RETAIL MERCHANDISING

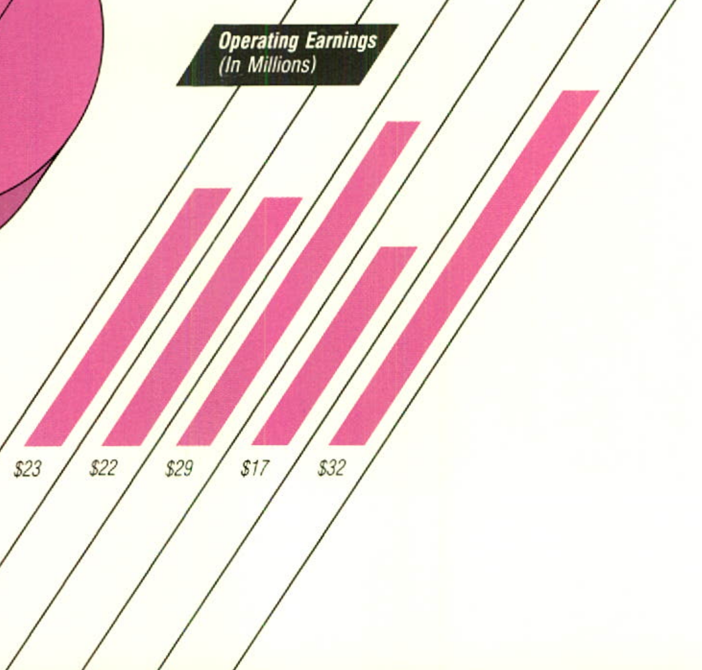
The operating earnings of INTERCO's General Retail Merchandising Group improved substantially over the prior year's disappointing results. Sales also increased moderately on the basis of continuing operations.

Sales were $461.8 million in fiscal 1986, compared with year ago reported sales of $545.3 million. On a comparable basis, sales volume for those retail companies not affected by the asset redeployment program increased 0.9 percent. Operating earnings were $32.1 million versus $17.3 million the prior year. Return on sales of 6.9 percent compared with 3.2 percent in fiscal 1985.

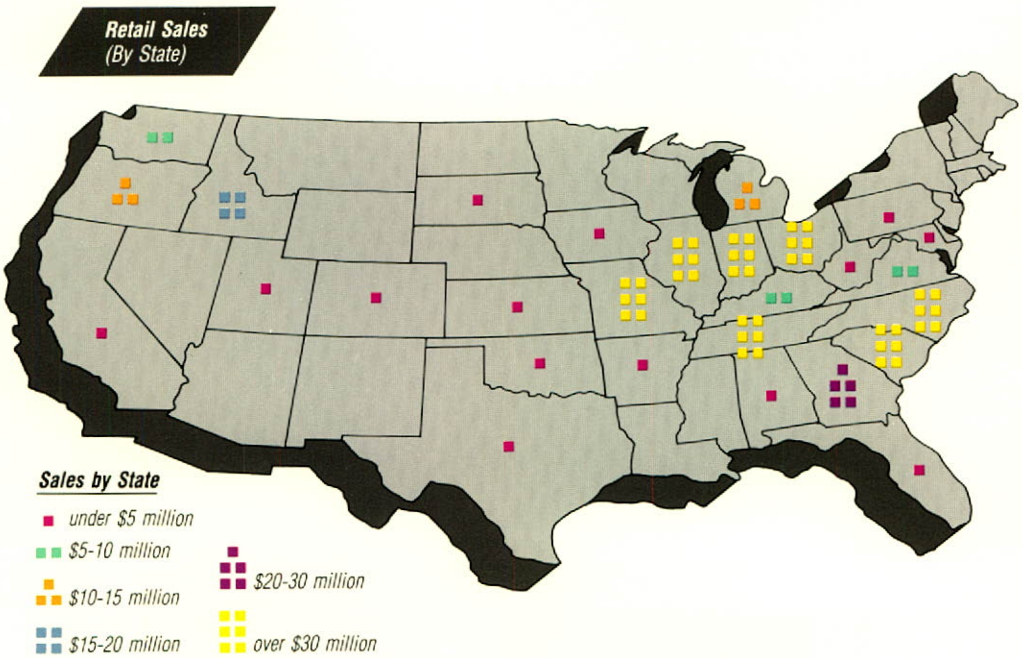
Much of the General Retail Merchandising Group's successful fiscal 1986 performance was due to a more selective approach with respect to promotional activities together with improved merchandising programs. The Group also benefited from its strategic direction in serving well-defined market sectors offering favorable long-term growth. In each of these sectors, INTERCO's operating companies are industry leaders. For example, *Central Hardware* is the dominant do-it-yourself home improvement retailer in all of its markets. It has achieved this position as a result of an extensive merchandise selection, quality products, competitive prices and dedication to customer service. In addition, it has strategically placed home-improvement centers in locations serving selected Midwest metropolitan areas.

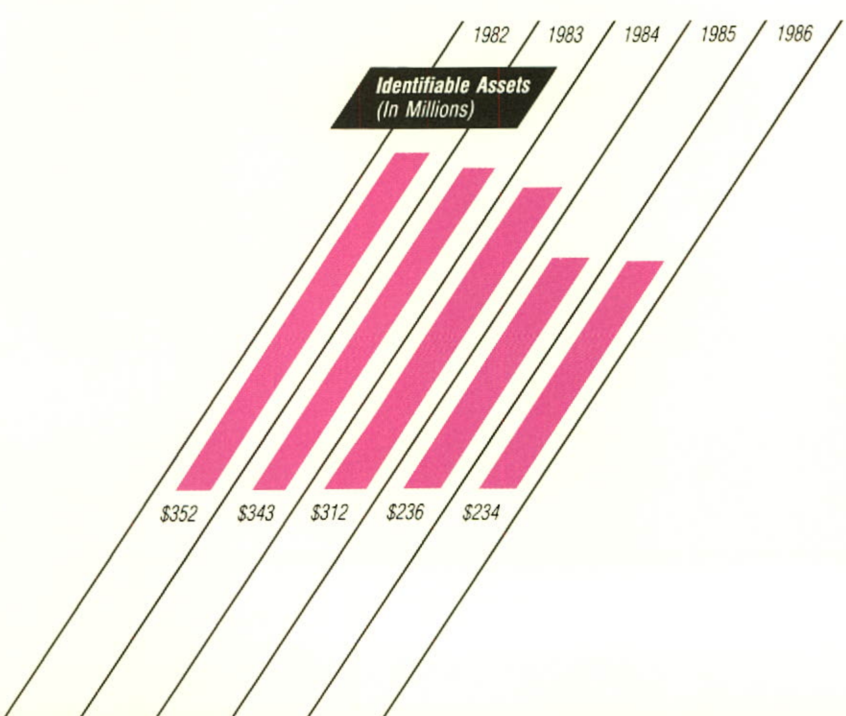






Other retailing operations, such as *Sky City, Golde's, Fine's* and *United*, serve targeted markets in which they are also leaders, either in terms of the communities served or specific market segments. These stores benefit from favorable consumer recognition and demographics. For example, *Sky City*, serving primarily the Southeastern United States, is generally located in towns and smaller cities with stable or growing populations.





Major Retail Trading Names:
Benchley
Carithers
Central Hardware
Falk's ID
Fine's
Golde's
Idaho Department Store
Jeans Galore
Keith O'Brien
Sky City Discount Center
United Shirt

INTERCO's emphasis on quality products and service appeals to the do-it-yourself consumer. *Golde's, Fine's, United* and *Sky City* also feature quality brand-name merchandise in attractive, conveniently located stores.

General Retail Merchandising

The General Retail Merchandising Group relies on highly motivated company management staying in touch with changes in their markets.

The reformatting of selected stores by *Central Hardware* was an adaptation of the warehouse concept which is becoming increasingly popular in certain areas. This new format has expanded productive selling space and is appealing to customers.

Sky City initiated a store remodeling program which provides added shopping convenience through well located merchandise displayed in a modern store setting. Customer response has been positive as measured by increased consumer traffic and average dollar purchases per customer.

Improved technology, such as enhanced point-of-sale management information systems installed at *Central Hardware* this past year, and to be installed at *Fine's* and *Sky City* stores during the coming year, will provide better sales information and inventory control to assist in responding quickly to market trends.

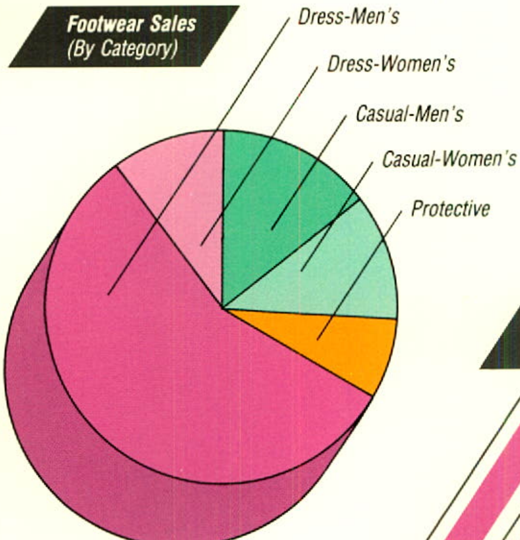
Cost reduction efforts include the installation of equipment and systems designed to combat rising occupancy costs such as heat, light and air conditioning. Longer term efforts include the opening of slightly smaller stores, to achieve lower operating costs while increasing sales per square foot through the use of updated displays and merchandising techniques.

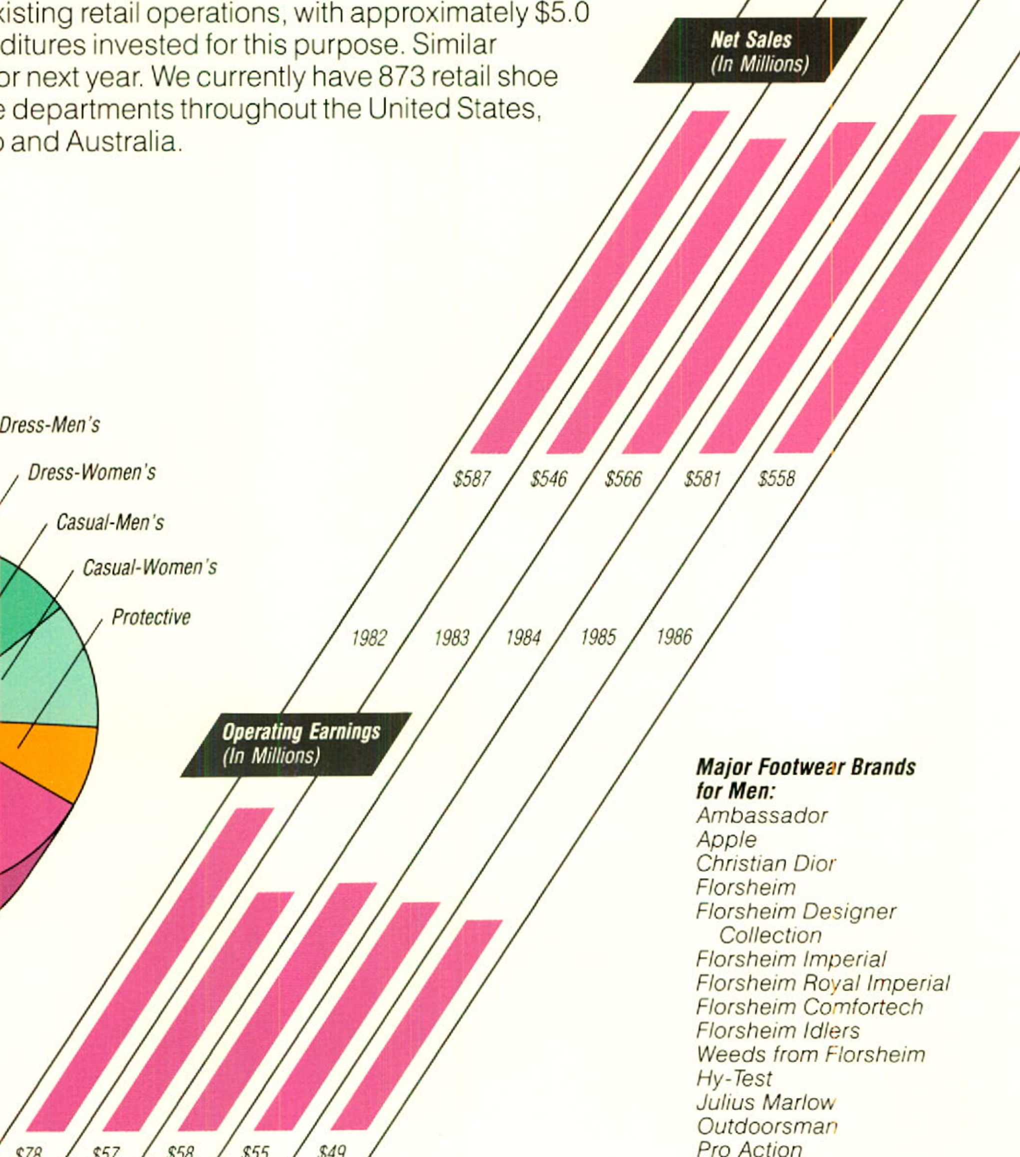
FOOTWEAR MANUFACTURING AND RETAILING

INTERCO's market position in footwear manufacturing and retailing is based on the highly visible presence of the *Florsheim* name and the broad distribution of other INTERCO brands in multiple markets through firmly established retail channels. Although unprecedented price competition in the footwear industry contributed to a decline in sales and operating earnings for the Group during the year, the company's market positioning enabled the Footwear Manufacturing and Retailing Group to outperform the industry as a whole.

Sales for the Group were $558.3 million compared with $580.4 million the prior year. Operating earnings of $48.5 million compared with the $54.7 million reported for last year. Return on sales was 8.7 percent versus 9.4 percent a year ago.

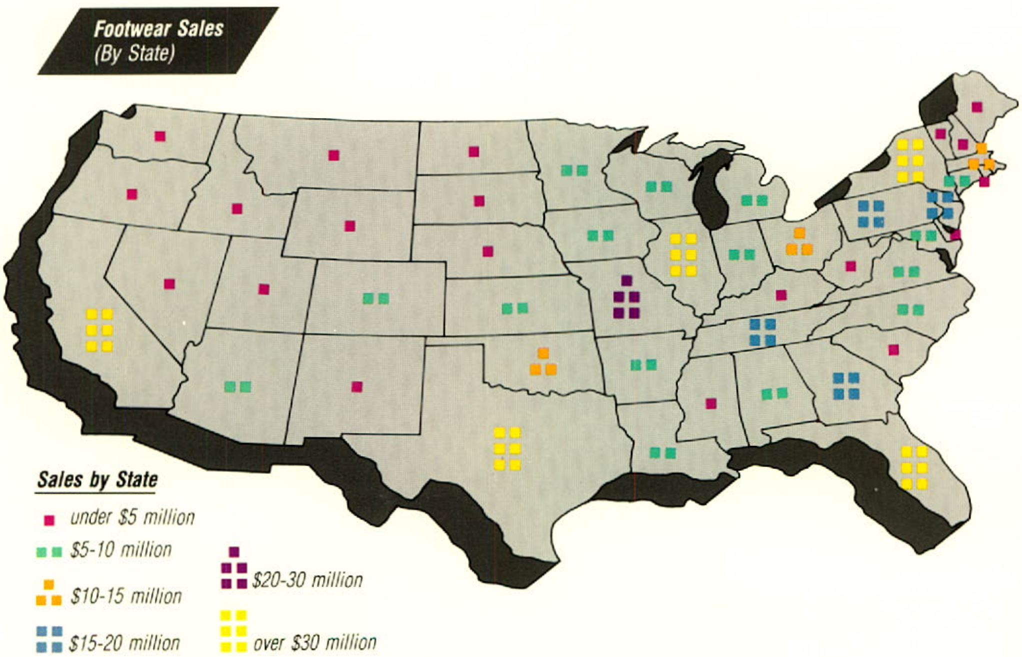
This year, the company continued to relocate marginal stores as well as to remodel and update existing retail operations, with approximately $5.0 million in capital expenditures invested for this purpose. Similar amounts are planned for next year. We currently have 873 retail shoe stores and leased shoe departments throughout the United States, and in Canada, Mexico and Australia.

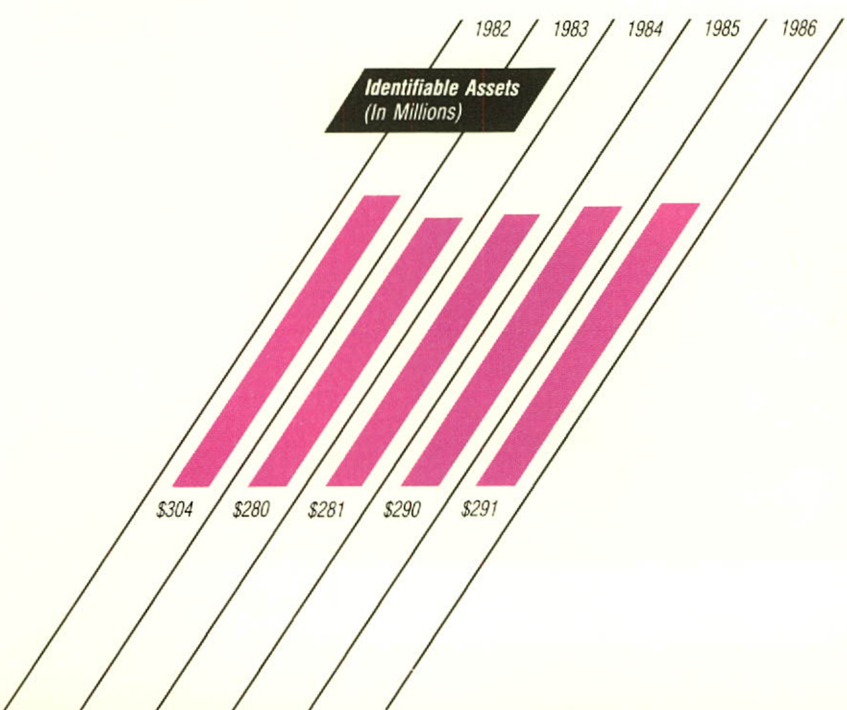




Major Footwear Brands for Men:
Ambassador
Apple
Christian Dior
Florsheim
Florsheim Designer Collection
Florsheim Imperial
Florsheim Royal Imperial
Florsheim Comfortech
Florsheim Idlers
Weeds from Florsheim
Hy-Test
Julius Marlow
Outdoorsman
Pro Action
Sea Tracs by London Fog
Winthrop
Worthmore

Additional new marketing channels are also being explored. Initial test results of the *Florsheim Electronic Retailing System* have been encouraging and a more substantial test phase will be conducted in the new year. *Florsheim* is also exploring a mini-store concept aimed at improving sales productivity per square foot while reducing space and other occupancy costs. During the current year, *Florsheim* will complete the installation of electronic data transmission and inventory management systems for its retail divisions. These systems are now contributing to improved merchandise availability and increased sales productivity in a substantial percentage of the company's retail locations.





Major Footwear Brands for Women:
Accent
Akimbo
Avenues
Crawdads
Eclaire
Florsheim
Florsheim Ramblers
J.G. Hook
Marshmallows
Sea Tracs by
London Fog
Suite 200
Thayer McNeil
Velvet Step

Major Retail Trading Names:
Florsheim Shoe Shops
Florsheim Thayer McNeil
Thompson, Boland & Lee

Mobile salesrooms allow workers to select *Hy-Test* safety shoes at convenient on-the-job locations. *Florsheim* and other INTERCO footwear is characterized by both superior styling and workmanship.

Footwear Manufacturing and Retailing

The goal of our Footwear Group is to provide quality products with superior performance characteristics. *Florsheim* has recently expanded its markets through the introduction of new products offering price points and design features targeted at additional segments while continuing to serve its traditional customers. The *Idler* and the growing *Comfortech* series which address markets for leisure and performance walking shoes exemplify this trend in line development. New product research efforts include the identification and use of new materials and manufacturing processes.

A new and exciting line of women's *Florsheim* footwear for the career woman has been introduced for the coming fall season. Styles will include dress pumps, open sandals, comfort casuals, walking shoes and tailored dress shoes. In addition, *International Shoe's Avenues* and *Marshmallows* lines also appeal to the career woman resulting in a strengthening of their respective market positions during fiscal 1986. Sales efforts have been accelerated in the marketing of *International Shoe's* new protective footwear, some of which utilize lighter weight fiberglass in their construction.

Despite the overall soft conditions prevalent in the footwear industry during the past few years, INTERCO's outstanding men's products and innovative marketing programs should provide additional growth opportunities for the Footwear Manufacturing and Retailing Group in the years ahead.

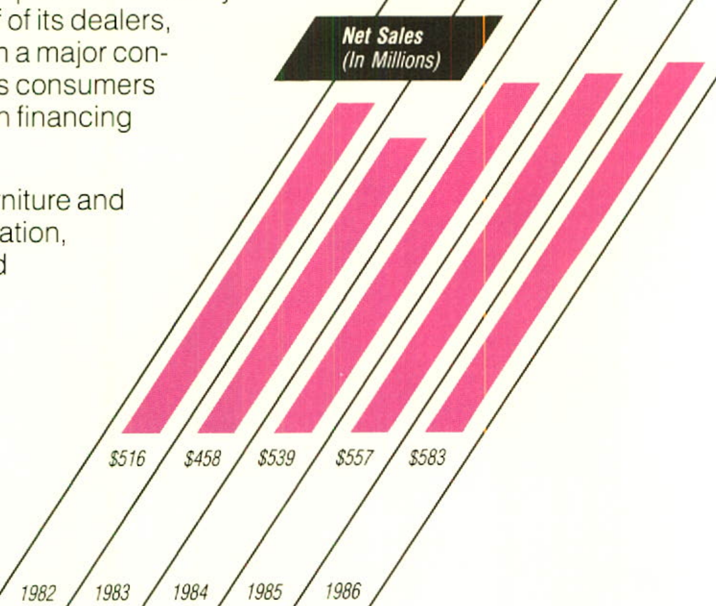
Furniture and Home Furnishings

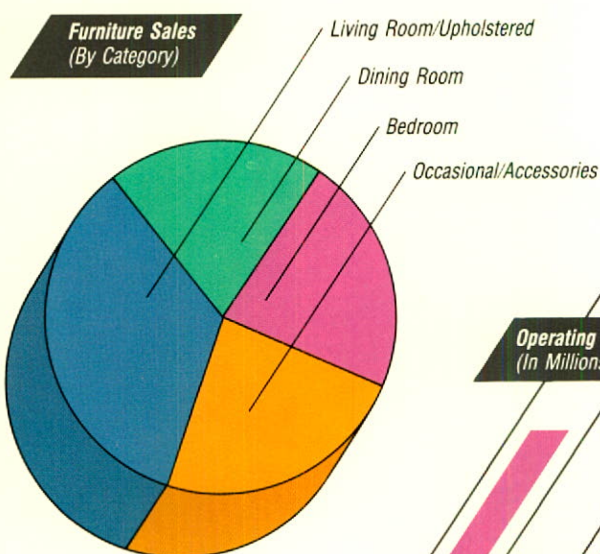
INTERCO's Furniture and Home Furnishings Group achieved increased sales and operating earnings in fiscal 1986. Sales for the Group were $582.8 million compared with $556.9 million for fiscal 1985. Operating earnings of $57.3 million compared with $53.9 million earned the prior year. Return on sales was 9.8 percent versus 9.7 percent last year.

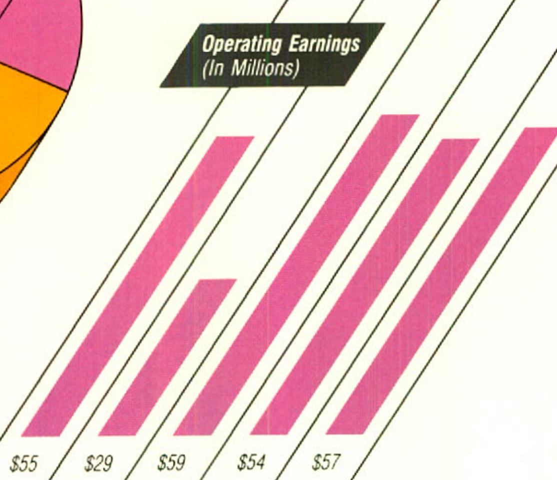
Broyhill and *Ethan Allen* continue to respond to consumer preferences in merchandise as well as customer service. Today's furniture purchaser not only wants quality products and in-house decorating assistance, but also prompt delivery. *Ethan Allen* continued its innovative home delivery program. This service provides not only timely delivery, but also allows the dealer to concentrate on selling and service to their customers.

To a degree, the furniture business is housing related. When mortgage interest rates are high, the level of housing starts and resultant furniture and home furnishings purchases are curtailed. In response to the early 1985 economic environment, *Ethan Allen*, on behalf of its dealers, negotiated a new installment financing program with a major consumer finance company. This arrangement provides consumers an opportunity to borrow at favorable interest rates in financing purchases from dealers.

As evidence of the opportunities available to the Furniture and Home Furnishings Group to increase market penetration, *Broyhill's Showcase Gallery* program was expanded

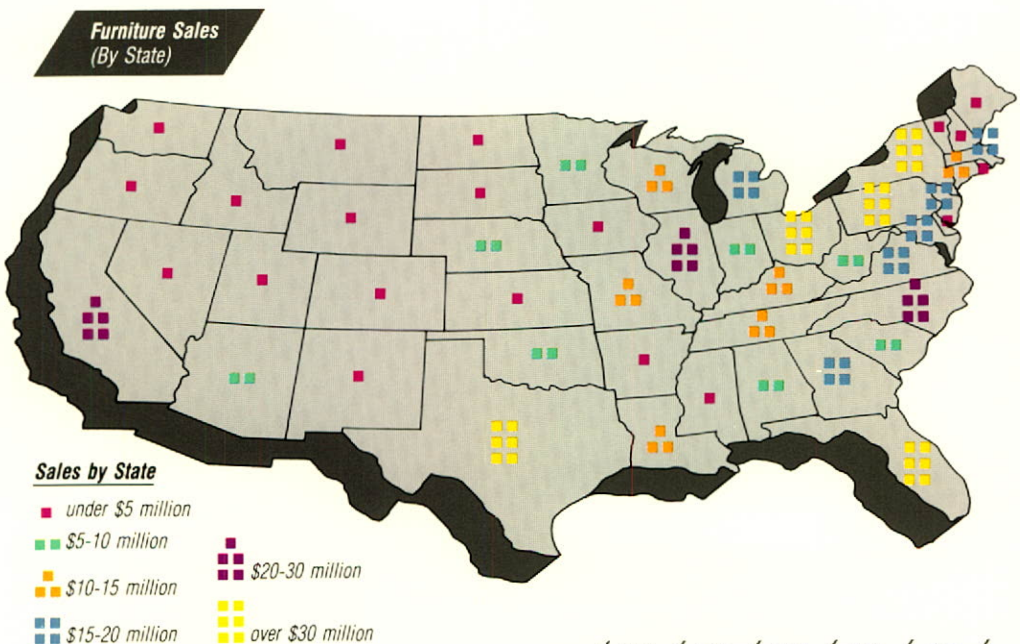






to 215 galleries at year end, an increase of 50 over the prior year. Most participating dealers have experienced increased sales per square foot, broadening *Broyhill's* market penetration. The *Broyhill Showcase Gallery* includes a broad range of furniture and accessories.

Demographic trends continue to benefit the Furniture and Home Furnishings Group. Two-career families have more income available to purchase quality furniture. In addition, many of these families which postponed having children when beginning their careers, are now growing and in need of larger homes and additional furniture and home furnishings. There is also a growing importance attached to home lifestyle and home entertaining. *Ethan Allen's* recently introduced "Families First" marketing program emphasizes the importance of the home in family life.



Major Furniture and Home Furnishings Brands:
Broyhill
Broyhill Premier
Ethan Allen
Kling
Knob Creek
Lenoir House
Restocrat

Major Retail Trading Names:
Broyhill Showcase Gallery
Carriage House
Georgetown
Georgetown Manor
Manor House

Today's accent on family living and home entertaining is only one reason why consumers prefer the quality which is synonymous with the *Ethan Allen* and *Broyhill* brand names.

Furniture and Home Furnishings

During the past year, *Ethan Allen* added several new lines of furniture including the *Canova Collection*, a contemporary transitional group of dining room furniture. *Ethan Allen* also expanded its selection of coordinated home furnishings, including lamps and lighting, clocks, fabrics, wallpaper, floor coverings and accessories. Plans have been formulated to introduce a significant new collection of upholstered furniture in the spring of 1986. *Ethan Allen Galleries* continued to be upgraded in displaying a "total home environment," while interior designer sales professionals received additional training in serving today's value-conscious consumer. Such training is in line with *Ethan Allen's* objective of becoming a single-source supplier of furniture and home furnishings.

In response to market conditions, *Broyhill* introduced additional computer-controlled manufacturing techniques, resulting in increased yield on lumber and fabrics used in manufacturing products, thus enhancing value to the consumer while maintaining quality. Similar investments were made at *Ethan Allen*. Capital expenditures for the Furniture Group in total exceeded $16 million this past year.

INTERCO's Furniture and Home Furnishings Group should benefit from demographic trends, an improved economy and lower interest rates during the coming year. Housing starts should remain at favorable levels in 1986. Equally important, in terms of INTERCO's market, is the forecast that single-family home resales will increase during the coming year.

Principal Companies of INTERCO

Apparel Manufacturing Group

Abe Schrader Corporation
New York, New York

Big Yank Corporation
New York, New York

The Biltwell Company, Inc.
St. Louis, Missouri

Campus Sportswear Company
Paramus, New Jersey

College-Town
Braintree, Massachusetts

Cowden Manufacturing Company
Lexington, Kentucky

Devon Apparel
Philadelphia, Pennsylvania

International Hat Company
St. Louis, Missouri

Londontown Corporation
Eldersburg, Maryland

Queen Casuals, Inc.
Philadelphia, Pennsylvania

Stuffed Shirt Inc.
New York, New York

General Retail Merchandising Group

Central Hardware Company
St. Louis, Missouri

Fine's Men's Shops, Incorporated
Norfolk, Virginia

Golde's Department Stores, Inc.
St. Louis, Missouri

Idaho Department Stores Co.
Caldwell, Idaho

Sky City Stores, Inc.
Asheville, North Carolina

United Shirt Distributors, Inc.
Detroit, Michigan

Footwear Manufacturing and Retailing Group

The Florsheim Shoe Company
Chicago, Illinois

International Shoe Company
St. Louis, Missouri

Senack Shoes, Inc.
St. Louis, Missouri

Furniture and Home Furnishings Group

Broyhill Furniture Industries, Inc.
Lenoir, North Carolina

Ethan Allen Inc.
Danbury, Connecticut

INTERCO CONSOLIDATED FINANCIAL STATEMENTS

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CONSOLIDATED BALANCE SHEET
(Dollars in thousands)

Assets	February 28, 1986	February 28, 1985	February 29, 1984
Current assets:			
Cash	$ 12,194	$ 12,992	$ 11,996
Marketable securities	98,123	32,465	114,603
Receivables, less allowances of $17,768 ($16,834 in 1985 and $15,318 in 1984)	333,553	335,258	329,054
Inventories	609,017	615,267	641,235
Prepaid expenses and other current assets	21,039	30,789	22,654
Total current assets	1,073,926	1,026,771	1,119,542
Property, plant and equipment:			
Land	25,015	25,071	25,075
Buildings and improvements	387,340	375,168	376,829
Machinery and equipment	269,911	256,761	257,039
	682,266	657,000	658,943
Less accumulated depreciation	287,224	255,908	250,578
Net property, plant and equipment	395,042	401,092	408,365
Other assets	94,872	107,378	79,925
	$1,563,840	$1,535,241	$1,607,832

See accompanying notes to consolidated financial statements.

Liabilities and Shareholders' Equity	**February 28, 1986**	February 28, 1985	February 29, 1984
Current liabilities:			
Current maturities of long-term debt and capital lease obligations	**$ 9,647**	$ 20,889	$ 19,669
Accounts payable	**138,652**	148,298	156,227
Accrued employee compensation	**36,928**	38,582	39,249
Other accrued expenses	**33,530**	33,959	34,001
Income taxes	**7,987**	3,710	17,549
Total current liabilities	**226,744**	245,438	266,695
Long-term debt, less current maturities	**127,409**	133,311	139,914
Obligations under capital leases, less current maturities	**56,495**	61,403	69,002
Other long-term liabilities	**41,899**	30,325	31,258
Shareholders' equity:			
Preferred stock, no par value, authorized 10,000,000 shares—issued 660,273 shares in 1986, 733,037 shares in 1985 and 802,085 shares in 1984	**66,027**	73,304	80,209
Common stock, $7.50 stated value, authorized 50,000,000 shares—issued 15,871,692 shares in 1986, 15,613,525 shares in 1985 and 15,420,324 shares in 1984	**119,038**	117,102	115,652
Capital surplus	**102,380**	91,496	84,242
Retained earnings	**905,587**	863,019	843,635
	1,193,032	1,144,921	1,123,738
Less 1,561,464 (1,536,915 and 587,465 in 1985 and 1984, respectively) shares of common stock in treasury, at cost	**81,739**	80,157	22,775
Total shareholders' equity	**1,111,293**	1,064,764	1,100,963
	$1,563,840	$1,535,241	$1,607,832

CONSOLIDATED STATEMENT OF EARNINGS

(Dollars in thousands except per share data)

Years Ended	**February 28, 1986**	February 28, 1985	February 29, 1984
Income:			
Net sales	**$2,510,740**	$2,625,746	$2,678,886
Other income, net	**32,230**	31,852	44,495
	2,542,970	2,657,598	2,723,381
Costs and expenses:			
Cost of sales	**1,725,343**	1,813,934	1,820,366
Selling, general and administrative expenses	**613,249**	638,151	650,332
Interest expense	**25,523**	26,400	31,662
Asset redeployment expenses	**—**	35,010	—
	2,364,115	2,513,495	2,502,360
Earnings before income taxes	**178,855**	144,103	221,021
Income taxes	**86,508**	71,940	104,827
Net earnings	**$ 92,347**	$ 72,163	$ 116,194
Earnings per share	**$5.84**	$4.45	$7.02

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

(Dollars in thousands)

Years Ended	February 28, 1986	February 28, 1985	February 29, 1984
Working capital provided by:			
Net earnings	**$ 92,347**	$ 72,163	$116,194
Items not affecting working capital:			
Depreciation	**44,853**	44,643	42,524
Other, net	**13,860**	5,886	10,509
Operations	**151,060**	122,692	169,227
Disposal of property, plant and equipment	**5,922**	24,177	10,400
Issuance of preferred stock	**249**	17	29
Issuance of common stock	**13,412**	9,381	20,665
Additions to long-term debt	**158**	12,919	5,100
Additions to capital lease obligations	**1,409**	2,337	3,431
Other, net	**10,058**	—	—
	182,268	171,523	208,852
Working capital used for:			
Cash dividends	**49,094**	50,330	48,631
Additions to property, plant and equipment:			
Company owned property	**43,362**	56,023	47,627
Capitalized leased property	**1,409**	2,337	3,431
Reduction of long-term debt	**6,537**	19,137	58,687
Reduction of capital lease obligations	**6,317**	11,724	8,214
Purchase of common treasury shares	**2,250**	58,057	—
Conversion of preferred stock	**7,450**	6,924	10,638
Acquisition (less working capital of $19,126)	**—**	19,119	—
Other, net	**—**	19,386	7,619
	116,419	243,037	184,847
Increase (decrease) in working capital	**$ 65,849**	$ (71,514)	$ 24,005
Working capital increased (decreased) by:			
Cash and marketable securities	**$ 64,860**	$ (81,142)	$ 11,054
Receivables	**(1,705)**	6,204	37,924
Inventories	**(6,250)**	(25,968)	(1,079)
Prepaid expenses and other current assets	**(9,750)**	8,135	4,593
Current maturities	**11,242**	(1,220)	813
Accounts payable and accrued expenses	**11,729**	8,638	(29,761)
Income taxes	**(4,277)**	13,839	461
	$ 65,849	$ (71,514)	$ 24,005

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(Dollars in thousands except per share data)

	Preferred Stock	Common Stock Issued	Common Stock Treasury	Capital Surplus	Retained Earnings	Total
Balance February 28, 1983	$ 90,814	$113,348	$(26,682)	$ 66,885	$778,866	$1,023,231
Net earnings					116,194	116,194
Cash dividends:						
Preferred stock					(6,701)	(6,701)
Common stock–$2.88 per share					(41,930)	(41,930)
Conversion of debentures:						
Series D–329 shares	33			(4)		29
Conversion of preferred stock:						
Series D–106,380 shares	(10,638)	1,725		8,911		(2)
Exercise of stock options:						
Common–77,142 shares		578		3,174		3,752
Restricted stock plan:						
Common–133 shares		1		7		8
Issuance of 100,000 common treasury shares in exchange for notes			3,907	5,269	(2,907)	6,269
Foreign currency translations					113	113
Balance February 29, 1984	80,209	115,652	(22,775)	84,242	843,635	1,100,963
Net earnings					72,163	72,163
Cash dividends:						
Preferred stock					(5,985)	(5,985)
Common stock–$3.03 per share					(44,345)	(44,345)
Conversion of debentures:						
Series D–189 shares	19			(2)		17
Conversion of preferred stock:						
Series D–69,237 shares	(6,924)	1,123		5,800		(1)
Exercise of stock options:						
Common–43,518 shares		327		1,469		1,796
Purchase of 960,500 common treasury shares			(58,057)			(58,057)
Issuance of 11,050 common treasury shares to ESOP			675	(13)		662
Foreign currency translations					(2,449)	(2,449)
Balance February 28, 1985	73,304	117,102	(80,157)	91,496	863,019	1,064,764
Net earnings					92,347	92,347
Cash dividends:						
Preferred stock					(5,405)	(5,405)
Common stock–$3.08 per share					(43,689)	(43,689)
Conversion of debentures:						
Series D–1,734 shares	173			76		249
Conversion of preferred stock:						
Series D–74,498 shares	(7,450)	1,208		6,241		(1)
Exercise of stock options:						
Common–97,111 shares		728		4,501		5,229
Purchase of 35,100 common treasury shares			(2,250)			(2,250)
Issuance of 10,551 common treasury shares to ESOP			668	66		734
Foreign currency translations					(685)	(685)
Balance February 28, 1986	$ 66,027	$119,038	$(81,739)	$102,380	$905,587	$1,111,293

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(Dollars in thousands except per share data)

1. Significant Accounting Policies

The company and its subsidiaries follow generally accepted accounting principles to present fairly their consolidated financial position, results of operations, and changes in financial position. The major accounting policies of the company are set forth below.

Principles of Consolidation–The consolidated financial statements include the accounts of the company and all its subsidiaries, the majority of which are wholly owned. All material intercompany transactions have been eliminated in consolidation.

Fiscal Year–The company's fiscal year ends on the last day of February.

Marketable Securities–Marketable equity securities (common and preferred stocks) are stated at the lower of cost or market. Aggregate net unrealized losses are included in results of operations if related to current assets and in shareholders' equity if related to non-current assets. Other marketable securities are stated at cost, which approximates market value, unless there is an indication of permanent impairment of value, in which case the adjustment to market value is included in results of operations. The cost of marketable securities sold is determined on the specific identification method.

Inventories–Inventories are stated at the lower of cost (first-in, first-out) or market, except for most footwear manufacturing and certain general retail inventories which are valued on the "last-in, first-out" method of inventory valuation.

Property, Plant and Equipment–Property, plant and equipment, including facilities and equipment leased under capital leases, are stated at cost. Expenditures for improvements are capitalized, while normal repairs and maintenance are expensed as incurred. When properties are retired or otherwise disposed of, the related cost and accumulated depreciation or amortization are removed from the accounts and gains or losses on the dispositions are reflected in results of operations.

For financial reporting purposes, the company utilizes both accelerated and straight-line methods of computing depreciation and amortization. Such expense is computed based on the estimated useful lives of the respective assets or term of lease, if less, which generally range from 15 to 40 years for buildings and improvements, and from 3 to 20 years for machinery and equipment. Approximately 80% of depreciation and amortization expense was computed using the straight-line method in each fiscal year presented.

Excess of Cost Over Fair Value of Net Assets Acquired–The excess of cost over fair value of net assets of companies acquired is included in other assets and is being amortized on a straight-line basis, generally over 40 years.

Start-Up Expenses–Start-up expenses of new facilities are charged to results of operations in the fiscal year incurred.

Pension Plans–For financial reporting purposes, the company's policy is to provide for current costs and amortization of prior service costs over 30 years. Amounts funded meet or exceed the funding requirements of the Employee Retirement Income Security Act of 1974.

Income Taxes–Deferred income taxes are provided on transactions which are reported for financial reporting purposes in different periods than for income tax purposes. Investment tax credits are reflected as a reduction of Federal income taxes in the period in which qualified property is placed in service. It is the company's intent that the undistributed earnings of its subsidiaries will either be reinvested in the subsidiaries or distributed tax-free to the parent company. Generally, no provision has been made for income taxes on such undistributed earnings.

(Dollars in thousands except per share data)

2. Business Combination

On March 15, 1984, the company acquired all the outstanding stock of Abe Schrader Corporation for $38,245 in cash. This transaction was accounted for as a purchase, and accordingly, the results of operations of Abe Schrader Corporation have been included in the company's consolidated statement of earnings from the date of the acquisition.

3. Inventories

Inventories are summarized as follows:

	1986	1985	1984
Retail merchandise	**$236,326**	$230,329	$256,746
Finished products	**209,455**	201,478	191,715
Work in process	**49,100**	55,724	57,610
Raw materials	**114,136**	127,736	135,164
	$609,017	$615,267	$641,235

All of the major categories of inventory include certain items valued on the "last-in, first-out" method. Had the "first-in, first-out" method been applied to all inventories, they would have been stated at approximately $640,874, $648,656 and $674,193 at fiscal years ended 1986, 1985 and 1984, respectively.

4. Lines of Credit

The company has a revolving credit agreement with a number of U.S. banks which enables it to borrow up to $100,000 in domestic or Euro-Dollar loans through February 28, 1987. Borrowings outstanding as of February 28, 1987, are repayable from that date through February 28, 1991. Domestic interest rates will approximate bank prime while rates for Euro-Dollar borrowings will approximate the London Inter-Bank Offering Rate plus 0.375%. The agreement requires the company to pay a commitment fee of 0.25% per annum. There were no borrowings outstanding under the agreement at fiscal years ended 1986, 1985 and 1984.

The company also maintains other bank lines of credit which provide added credit availability and support for the sale of commercial paper. On February 28, 1986, the total unused lines of credit under these agreements were $72,000.

Average short-term borrowings outstanding during fiscal 1986 and 1985 were $27,000 and $20,000, respectively, with a weighted average interest rate thereon of 7.8% and 10.4%, respectively. Maximum short-term borrowings at any month-end were $41,000 and $33,000 in fiscal 1986 and 1985, respectively. There were no short-term borrowings during fiscal 1984.

5. Long-Term Debt

Long-term debt consisted of the following:

	1986	1985	1984
14¼% promissory notes due February 15, 1991	**$ 75,000**	$ 75,000	$ 75,000
4⅝% promissory installment notes, payable $1,875 annually through 1987, and balance in 1988	**4,088**	5,963	7,838
8⅝% promissory installment note, payable $1,000 annually through 1993, and balance in 1994	**13,000**	14,000	15,000
8% to 12% industrial revenue bonds payable in varying amounts through 2011	**37,132**	37,651	29,726
Other debt at 5% to 9% interest rates, payable in varying amounts through 2006	**3,847**	17,711	28,188
	133,067	150,325	155,752
Less current maturities	**3,983**	15,066	13,622
Less market adjustment	**1,675**	1,948	2,216
	$127,409	$133,311	$139,914

Maturities of long-term debt are $3,983, $5,743, $2,017, $3,482 and $80,490 for fiscal years 1987 through 1991, respectively.

The market adjustment relates to purchase adjustments of the long-term debt assumed in the acquisition of Ethan Allen, Inc.

In fiscal 1984, the company exchanged 100,000 shares of its common stock plus $5,586 in cash for 66.7% of its 4⅝% promissory notes outstanding with a face value of $15,912. Also, the company purchased $25,000 of its 14¼% promissory notes at a premium of 8.714%. The combined effect of these transactions did not have a material effect on consolidated net earnings.

The 14¼% promissory notes may be redeemed on February 15, 1988, at the principal amount, without premium.

The company is in compliance with the covenants of its debt agreements and does not believe that the covenants will restrict its future operations.

6. Obligations Under Capital Leases

The amount capitalized under capital leases is the lesser of the present value of the minimum lease payments or the fair value of the leased properties at the beginning of the respective lease terms. Generally, interest rates applicable to capital leases range between 4¾% and 13¼% for leased facilities and between 12% and 18½% for leased equipment. Obligations under capital leases amounted to $62,159, $67,226 and $75,049 at fiscal years ended 1986, 1985 and 1984, respectively. Maturities of these obligations are $5,664, $5,539, $5,479, $6,213 and $4,829 for fiscal years 1987 through 1991, respectively.

7. Preferred Stock

The company's preferred stock is issuable in series. At fiscal years ended 1986, 1985 and 1984, the outstanding preferred stock consisted of 660,273, 733,037 and 802,085 shares, respectively, of Series D $7.75 cumulative convertible with stated and involuntary liquidating value of $100.00 per share.

Each share of the Series D preferred stock is convertible into 2.1621 shares of the company's common stock. Subject to the satisfaction of certain conditions relating to common stock dividends paid, the Series D preferred stock may be redeemed at the company's option at $107.75 per share, decreasing to $104.75 per share on January 29, 1989. The Series D preferred stock may be redeemed at the company's option on or after January 29, 1989, at $104.75 per share, decreasing to $100.00 per share in 1994.

8. Common Stock

Shares of common stock were reserved for the following purposes at February 28, 1986:

	Number of Shares
Common stock options:	
Granted	400,378
Available for grant	298,638
Conversion of preferred stock	1,427,576
	2,126,592

On June 24, 1985, the shareholders approved the INTERCO INCORPORATED 1985 Stock Option Plan authorizing the granting of incentive options, non-qualified options, stock appreciation rights, or combinations thereof to key employees, including officers, at 100% of fair market value on the date of grant. At February 28, 1986, no options or rights had been granted under this Plan.

(Dollars in thousands except per share data)

Under the company's stock option plans, certain key employees may be granted incentive options, nonqualified options, stock appreciation rights, or combinations thereof. Nonqualified options and stock appreciation rights granted under the 1977 Plan may not be less than 85% of the fair market value (100% as to incentive options and related stock appreciation rights) of the common stock on the date of grant. Options and stock appreciation rights granted under the 1980 Plan may not be less than 100% of the fair market value of the common stock on the date of grant. All options which have been granted, incentive or nonqualified, were at 100% of fair market value on the date of grant. Incentive options and nonqualified options expire ten years after the date of grant. At February 28, 1986, no stock appreciation rights have been granted.

At February 28, 1986, information regarding options granted but not exercised was as follows:

	Option Shares Outstanding	Dates of Grant	Price Range
1977 Plan	46,431	November 17, 1978 —October 7, 1985	$35.00 -$73.50
1980 Plan	353,947	December 19, 1980 —January 21, 1986	$40.375-$68.75

Changes in options granted are summarized as follows:

	1986		1985		1984	
	Shares	**Average Price**	Shares	Average Price	Shares	Average Price
Beginning of year	**519,890**	**$52.57**	331,924	$47.92	418,069	$46.08
Granted	**5,750**	**66.35**	265,950	56.24	10,400	64.58
Exercised	**(97,111)**	**48.20**	(43,518)	40.17	(77,142)	40.37
Cancelled	**(28,151)**	**54.37**	(34,466)	51.76	(19,403)	47.20
End of year	**400,378**	**53.70**	519,890	52.57	331,924	47.92
Exercisable at end of year	**129,727**		135,847		101,117	

In fiscal 1986, the company declared a dividend of one Common Share Purchase Right for each then outstanding share of common stock. In addition, one right has been or will be issued with each share of common stock issued by the company after October 4, 1985, and before the date the rights become exercisable, are redeemed by the company, or expire on October 4, 1990. The rights will not be exercisable, or transferable apart from the common stock, until ten days after another person or group of persons acquires 20% or more of the common stock or commences, or announces its intention to commence, a tender or exchange offer for 30% or more of the common stock. Each right entitles its holder to buy one share of common stock at an exercise price of $150.00. In certain circumstances, the rights will entitle their holders to purchase larger amounts of common stock or stock in an acquiring company. In addition to the shares reserved above, an additional 17,998,284 shares have been reserved under this plan.

9. Income Taxes

Income tax expense was comprised of the following:

	1986	1985	1984
Current:			
Federal	**$57,261**	$68,583	$ 91,304
State and local	**10,104**	10,438	11,274
Foreign	**2,398**	1,527	1,205
	69,763	80,548	103,783
Deferred	**16,745**	(8,608)	1,044
	$86,508	$71,940	$104,827
ESOP, investment and jobs tax credits	**$ 3,394**	$ 3,074	$ 2,632

The following table reconciles the differences between the Federal corporate statutory rate and the company's effective income tax rate:

	1986	1985	1984
Federal corporate statutory rate	**46.0%**	46.0%	46.0%
State and local income taxes, net of Federal tax benefit	**3.2**	4.3	2.9
ESOP, investment and jobs tax credits	**(1.7)**	(2.1)	(1.2)
Foreign taxes, including foreign currency translation effects	**0.3**	(0.2)	(0.2)
Other	**0.6**	1.9	(0.1)
Effective income tax rate	**48.4%**	49.9%	47.4%

Certain items are recognized for income tax purposes in years other than those in which they are reported in the consolidated financial statements. Future income tax benefits and deferred credits at the end of each fiscal year are included in the accompanying consolidated balance sheet, as follows:

	1986	1985	1984
Prepaid expenses and other current assets	**$ 8,442**	$16,823	$10,236
Other long-term liabilities	**(21,688)**	(13,324)	(15,345)
	$(13,246)	$ 3,499	$ (5,109)

The Federal income tax returns of the company and its major subsidiaries have been examined through fiscal year ended February 28, 1982. The Federal income tax returns of the company and its major subsidiaries for the taxable years of 1983 and 1984 are currently in the process of examination. Management is of the opinion that the results of these examinations will have no material effect on the company's consolidated financial position or results of operations.

10. Employee Benefits

The company and its subsidiaries have pension plans covering substantially all employees, including certain employees in foreign countries. Total pension expense was $17,100, $17,600 and $19,400 in fiscal years ended 1986, 1985 and 1984, respectively. Accumulated plan benefits and plan net assets for the company's defined benefit plans as of the most recent valuation dates are presented below:

	1986	1985	1984
Actuarial present value of accumulated plan benefits:			
Vested	**$150,583**	$143,846	$133,232
Nonvested	**10,427**	10,182	10,609
	$161,010	$154,028	$143,841
Net assets (at market value) available for benefits	**$162,130**	$146,358	$135,536

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 7.7%, 7.7% and 7.6% in fiscal years ended 1986, 1985 and 1984, respectively.

(Dollars in thousands except per share data)

During fiscal 1985, the company initiated a new Savings Plan for Employees of INTERCO INCORPORATED and Affiliates and an INTERCO INCORPORATED Employee Stock Ownership Plan (ESOP). The total cost of these Plans for fiscal years ended 1986 and 1985 was $612, net of taxes of $1,307 and $589, net of taxes of $1,206, respectively.

The company provides certain health care and life insurance benefits for certain employees who reach retirement age. Retiree health and life insurance benefits are provided through insurance companies. Post-retirement health care and life insurance expense for fiscal years ended 1986 and 1985 was $1,422 and $1,470, respectively.

11. Lease Commitments

Substantially all of the company's retail outlets and certain other real properties and equipment are operated under lease agreements expiring at various dates through the year 2022. Leases covering retail outlets and equipment generally require, in addition to stated minimums, contingent rentals based on retail sales and equipment usage. Generally, the leases provide for renewal for various periods at stipulated rates.

Assets recorded under capital leases were as follows:

	1986	1985	1984
Land	**$ 783**	$ 783	$ 783
Buildings	**82,158**	82,476	90,072
Machinery and equipment	**9,360**	10,660	11,483
	92,301	93,919	102,338
Accumulated depreciation	**43,636**	39,948	40,127
	$48,665	$53,971	$ 62,211

Future minimum lease payments under capital leases, reduced by minimum rentals from subleases of $4,282 at February 28, 1986, aggregate $108,618 of which $62,159 is included in obligations under capital leases and current maturities, $36,586 represents interest, and the balance represents other costs of the leases including taxes, insurance and maintenance. Annual payments under capital leases are $12,071, $11,425, $10,841, $10,983 and $9,109 for fiscal years 1987 through 1991, respectively.

Total rent expense was as follows:

	1986	1985	1984
Basic rentals under operating leases	**$35,858**	$40,181	$42,925
Contingent rentals, operating and capital leases	**33,754**	32,571	31,186
	69,612	72,752	74,111
Less sublease rentals	**1,718**	2,181	1,979
	$67,894	$70,571	$72,132

Included in rent expense above is the cost of services provided by lessors of leased retail departments, estimated to aggregate $16,700, $15,500 and $14,200 in fiscal years 1986, 1985 and 1984, respectively.

Future minimum lease payments under operating leases, reduced by minimum rentals from subleases of $3,631, at February 28, 1986, aggregate $185,655. Annual payments under operating leases are $30,705, $27,935, $24,138, $20,560 and $17,546 for fiscal years 1987 through 1991, respectively.

12. Litigation

The company is or may become a defendant in a number of pending or threatened legal proceedings in the ordinary course of business. In the opinion of management, the ultimate liability, if any, of the company from all such proceedings will not have a material effect upon the consolidated financial position.

13. *Earnings Per Share*

Earnings per share are based on the weighted average number of shares of common stock and common stock equivalents outstanding during the year, plus those common shares which would have been issued if conversion of all preferred stock and convertible debentures had taken place at the beginning of each year or since date of issuance. Stock options, the exercise of which would result in dilution of earnings per share, are considered common stock equivalents. Net earnings for these computations are increased by the net interest expense on the convertible debentures. Primary earnings per share do not differ significantly from fully diluted earnings per share.

14. *Business Segment Information*

The company's four business segments are Apparel Manufacturing, General Retail Merchandising, Footwear Manufacturing and Retailing, and Furniture and Home Furnishings. Specific information, on an unaudited basis, relating to the operating companies and their products, which comprise each segment, is included on the inside front cover and on pages 8 through 23. Summarized financial information by business segment is as follows:

	1986	1985	1984
Net sales to unaffiliated customers:			
Apparel	**$ 907,833**	$ 943,077	$ 880,122
General Retail	**461,785**	545,322	693,914
Footwear	**558,286**	580,467	565,891
Furniture	**582,836**	556,880	538,959
Total	**$2,510,740**	$2,625,746	$2,678,886
Operating earnings:			
Apparel	**$ 66,716**	$ 83,062	$ 100,538
General Retail	**32,085**	17,277	28,951
Footwear	**48,475**	54,727	58,531
Furniture	**57,285**	53,882	59,231
	204,561	208,948	247,251
Asset redeployment expenses	**—**	(35,010)	—
Corporate expenses and interest cost	**(25,706)**	(29,835)	(26,230)
Earnings before income taxes	**$ 178,855**	$ 144,103	$ 221,021
Identifiable assets at year end:			
Apparel	**$ 456,972**	$ 463,277	$ 439,837
General Retail	**234,004**	235,697	312,034
Footwear	**291,292**	290,099	280,764
Furniture	**455,145**	454,580	430,202
	1,437,413	1,443,653	1,462,837
Corporate assets	**126,427**	91,588	144,995
Total	**$1,563,840**	$1,535,241	$1,607,832
Depreciation expense:			
Apparel	**$ 11,965**	$ 11,316	$ 9,931
General Retail	**8,294**	9,671	11,400
Footwear	**8,286**	7,976	7,880
Furniture	**14,478**	13,065	12,388
Capital expenditures:			
Apparel	**$ 13,433**	$ 10,815	$ 12,855
General Retail	**6,169**	14,338	10,114
Footwear	**8,114**	10,519	7,626
Furniture	**16,235**	19,646	15,872

On November 1, 1984, the company announced that it would accelerate its asset redeployment program under which certain operating divisions not meeting the long-term profitability requirements of the company would be sold or liquidated. To cover the estimated costs and expenses associated with the program, a pretax reserve of $35,010 ($20,000 after tax, or $1.23 per share) was provided in the third quarter ended November 30, 1984. Accordingly, the sales and earnings of the operating units involved in this program are not included in the results shown above for periods subsequent to September 1, 1984. If this program had been in effect for the entire year, net sales of the

(Dollars in thousands except per share data)

Apparel segment and the General Retail segment for fiscal 1985 would have been $936,633 and $457,866, respectively. Substantially all of the estimated expenses of the asset redeployment program were allocated to the General Retail segment.

Sales between business segments, which account for less than 1% of the sales of any one business segment, are considered immaterial and are netted against the sales of the respective segment. Operating earnings of the business segment include its sales less all operating expenses. Minority interests in certain subsidiaries are immaterial and have been included in corporate expenses and interest cost. Substantially all of the company's sales are made to unaffiliated customers. No customer accounted for 10% or more of consolidated sales. Foreign operations are not material.

Identifiable assets are those assets used by each segment in its operations. Corporate assets consist primarily of cash and marketable securities. The remaining assets of the operating units involved in the asset redeployment program are included in corporate assets under identifiable assets at fiscal years ended 1986 and 1985. Realized gains (losses) on the sale of marketable securities netted against corporate expenses and interest cost amounted to $4,345, $(90) and $3,207 for fiscal years ended 1986, 1985 and 1984, respectively.

15. *Quarterly Financial Information (Unaudited)*

Following is a summary of unaudited quarterly information for each of the years in the three year period ended February 28, 1986.

	First	Second	Third	Fourth
Net Sales:				
1986	**$588,954**	**$644,022**	**$694,704**	**$583,060**
1985	645,528	700,526	698,765	580,927
1984	617,495	694,886	742,533	623,972
Gross Profit:				
1986	**$177,067**	**$200,747**	**$208,031**	**$199,552**
1985	199,913	214,807	215,146	181,946
1984	188,645	215,095	237,258	217,522
Net Earnings:				
1986	**$ 11,204**	**$ 23,212**	**$ 27,032**	**$ 30,899**
1985	19,468	24,396	8,339	19,960
1984	17,253	27,625	35,550	35,766
Earnings Per Share:				
1986	**$0.71**	**$1.47**	**$1.71**	**$1.95**
1985	1.17	1.48	0.54	1.26
1984	1.04	1.67	2.15	2.16
Common Dividends Paid Per Share:				
1986	**$0.77**	**$0.77**	**$0.77**	**$0.77**
1985	0.72	0.77	0.77	0.77
1984	0.72	0.72	0.72	0.72
Common Stock Price Range (High-Low):				
1986	**70½-61⅛**	**72½-64¼**	**73⅝-62¾**	**79¾-67**
1985	61-56	62¾-55	60⅞-55¾	65¼-58⅜
1984	75¼-63¼	85-64¾	72½-64	70-58½

The closing market price of INTERCO's common and preferred stock at fiscal year end 1986 was $78 and $167⅝ per share, respectively.

Included in the fourth quarter of fiscal 1986 are certain favorable inventory adjustments approximating $7.0 million, net of tax, representing refinements of gross margin estimates used in the first three quarters of the year. Management believes such adjustments reflect the seasonality, fashion-consciousness, and promotional nature of certain of the markets served by the company.

Fiscal 1986 and the third and fourth quarters of fiscal 1985 reflect the effects of the asset redeployment program. The sales of the operating divisions included in the program

have been excluded from consolidated sales for periods subsequent to September 1, 1984. If this program had been in effect for all of fiscal 1985, net sales for the first and second quarter would have been $599,588 and $652,618, respectively. As a result of the program, the operating results of the effected divisions have been excluded for fiscal 1986 and the third and fourth quarters of fiscal 1985 and net earnings and earnings per share for the third quarter of fiscal 1985 were impacted by $20,000 and $1.23, respectively.

16. *Inflation Accounting (Unaudited)*

The accompanying inflation–adjusted financial information is presented in accordance with the requirements of the Financial Accounting Standards Board (FASB). As acknowledged by the FASB, the methods used to prepare this data are experimental and, because of necessity, are based on assumptions, estimates and subjective judgments.

The "current cost" method measures the effect of specific price changes on inventory, and property, plant and equipment as a result of inflation. The current cost of inventories was determined utilizing the first-in, first-out method of inventory valuation adjusted for unrecognized price increases through application of the Bureau of Labor Statistics Producer Price Index (BLS-PPI). The current cost of property, plant and equipment was determined using the appropriate BLS-PPI, other externally available indices, and management's estimates and appraisals.

The purpose of current cost restatement is to provide an estimate of the impact of price changes on net earnings and cash flow. The adjustment to cost of sales reflects the change in beginning and ending inventory levels as adjusted for increases in specific prices of inventory. The adjustment to depreciation reflects the increased expense associated with the current cost valuation of property, plant and equipment and was computed using the company's normal depreciation methods and depreciable life assumptions.

In accordance with FASB requirements, inflation-adjusted net earnings do not reflect an adjustment to historical income tax expense. As a result, the effective tax rates and net earnings on an inflation-adjusted basis are distorted.

The summary consolidated statement of earnings adjusted for inflation for the year ended February 28, 1986, is as follows:

	As Reported in the Consolidated Statement of Earnings	Adjusted for Specific Price Changes (Current Cost)
Net sales and other income	$2,542,970	$2,542,970
Cost of sales (excluding depreciation)	1,705,941	1,710,027
Selling, general and administrative expenses (excluding depreciation)	587,798	587,798
Depreciation expense	44,853	71,831
Interest expense	25,523	25,523
Income taxes	86,508	86,508
	2,450,623	2,481,687
Net earnings	$ 92,347	$ 61,283
Earnings per share	$5.84	$3.87
Effective income tax rate	48.4%	58.5%
Purchasing power gain (loss) on net monetary assets held		$ (200)
Increase in general inflation of inventories and net property, plant and equipment during the year		$ 54,178
Effect of increase in specific prices (current cost)		9,878
Excess of general inflation over specific price increases		$ 44,300

(Dollars in thousands except per share data)

The current costs of inventories and net property, plant and equipment were $637,664 and $629,408, respectively.

The following five-year comparison shows selected historical financial data adjusted for the effects of changing prices:

	1986	1985	1984	1983	1982
Current cost data:					
Net earnings	$ 61,283	$ 43,686	$ 92,632	$ 60,976	$ 82,824
Earnings per common share	3.87	2.69	5.59	3.71	5.05
Net assets at year end	1,374,306	1,347,595	1,386,916	1,384,509	1,324,563
Increase in general inflation over increase in specific prices of inventories and net property, plant and equipment	44,300	(301)	74,563	42,987	2,933
Other information adjusted for general inflation:					
Net sales and other income	2,542,970	2,752,725	2,937,264	2,893,701	3,174,712
Purchasing power gain (loss) on net monetary assets held	(200)	201	1,949	5,391	14,063
Dividends paid per common share	3.08	3.14	3.11	3.21	3.38
Market price of common stock at year end	$78.00	$64.22	$63.77	$70.21	$47.87
Average consumer price index	324.1	312.9	300.5	290.8	275.9

Independent Accountants' Report

The Board of Directors and Shareholders
INTERCO INCORPORATED:

We have examined the consolidated balance sheets of INTERCO INCORPORATED and subsidiaries as of February 28, 1986, February 28, 1985 and February 29, 1984 and the related consolidated statements of earnings, shareholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of INTERCO INCORPORATED and subsidiaries at February 28, 1986, February 28, 1985 and February 29, 1984 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co

St. Louis, Missouri
April 14, 1986

Five Year Consolidated Financial Review

(Dollars in thousands except per share data)

Years Ended	1986	1985	1984	1983	1982
For The Year					
Summary of operations:					
Net sales	**$2,510,740**	$2,625,746	$2,678,886	$2,566,606	$2,673,769
Cost of sales	**1,725,343**	1,813,934	1,820,366	1,759,527	1,820,369
Interest expense	**25,523**	26,400	31,662	35,072	37,201
Earnings before income taxes	**178,855**	144,103	221,021	165,876	223,270
As a percent of sales	**7.1%**	5.5%	8.3%	6.5%	8.4%
Income taxes	**86,508**	71,940	104,827	80,114	104,655
Net earnings	**92,347**	72,163	116,194	85,762	118,615
As a percent of sales	**3.7%**	2.7%	4.3%	3.3%	4.4%
Net earnings applicable to common stock	**92,351**	72,172	116,204	85,774	118,642
Per share of common stock:					
Earnings	**$5.84**	$4.45	$7.02	$5.22	$7.23
Dividends	**$3.08**	$3.03	$2.88	$2.88	$2.88
Average common and common equivalent shares outstanding (in thousands)	**15,820**	16,229	16,562	16,429	16,406
Cash dividends paid:					
On common stock	**$ 43,689**	$ 44,345	$ 41,930	$ 41,018	$ 40,683
On preferred stock	**$ 5,405**	$ 5,985	$ 6,701	$ 7,478	$ 7,809
At Year End					
Working capital	**$ 847,182**	$ 781,333	$ 852,847	$ 828,842	$ 785,328
Property, plant and equipment, net	**395,042**	401,092	408,365	409,973	417,107
Capital expenditures:					
Company owned property	**43,362**	56,023	47,627	36,144	48,353
Capitalized leased property	**1,409**	2,337	3,431	3,966	3,940
Total assets	**1,563,840**	1,535,241	1,607,832	1,554,975	1,538,950
Long-term debt	**127,409**	133,311	139,914	193,341	198,054
Obligations under capital leases	**56,495**	61,403	69,002	73,785	76,820
Shareholders' equity	**1,111,293**	1,064,764	1,100,963	1,023,231	985,072
Book value per common share	**$ 73.04**	$ 70.43	$ 68.82	$ 64.64	$ 62.36

BOARD OF DIRECTORS

Nathan S. Ancell
Chairman of the Board,
Ethan Allen Inc.

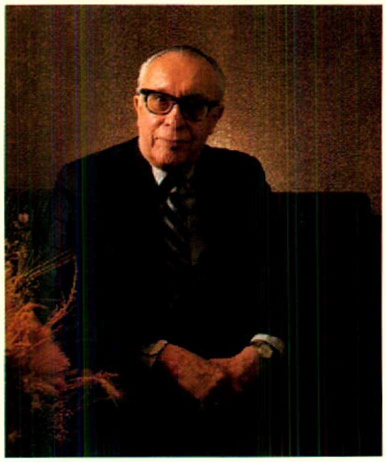
1, 4 **Ronald L. Aylward**
Vice Chairman of the Board
of the Company

2, 3, 4, 5 **Zane E. Barnes**
Chairman of the Board, President and Chief Executive Officer of Southwestern Bell Corporation, and President and Chief Executive Officer of Southwestern Bell Telephone Company

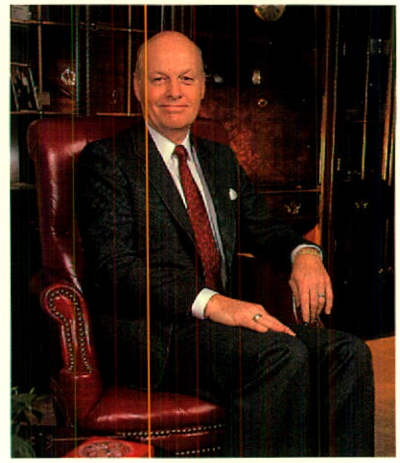
Stanley M. Cohen
Chairman of the Board,
Central Hardware Company

2, 3, 5 **Edwin S. Jones**
Retired

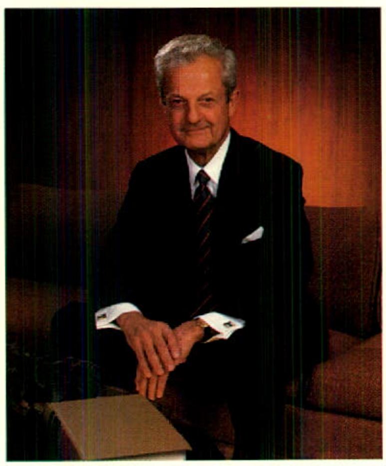
1 **Harry M. Krogh**
President and
Chief Operating Officer
of the Company



Nathan S. Ancell

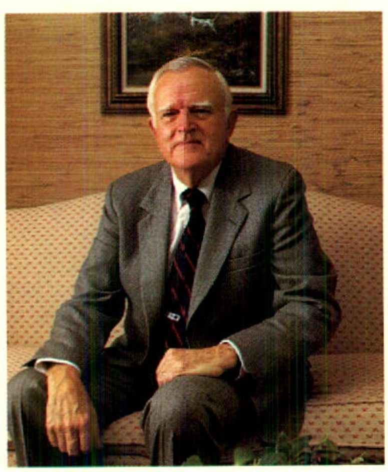


Ronald L. Aylward

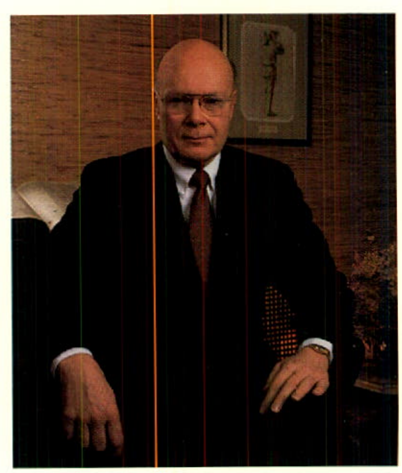


Zane E. Barnes

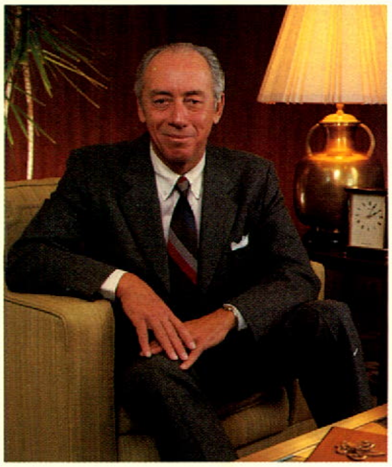
Stanley M. Cohen



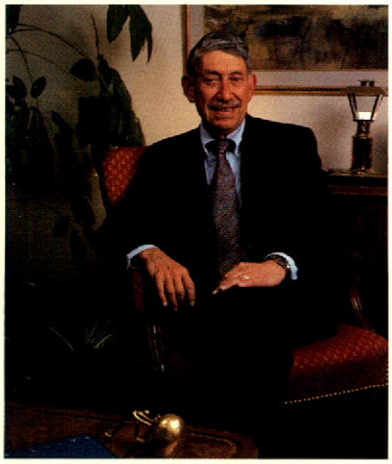
Edwin S. Jones



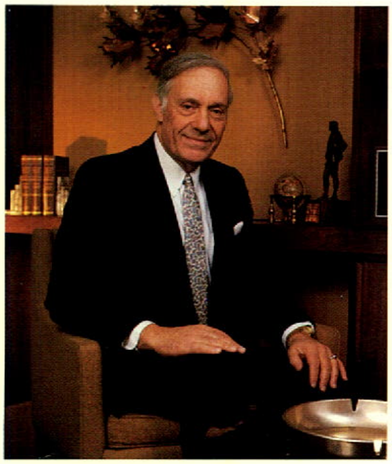
Harry M. Krogh



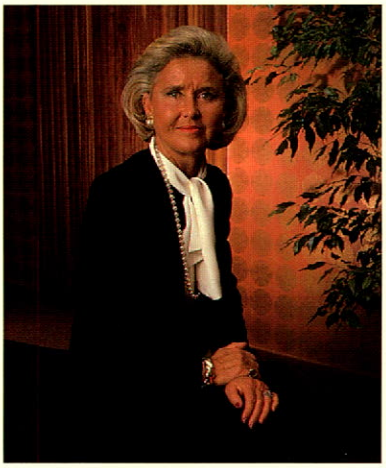
Donald E. Lasater



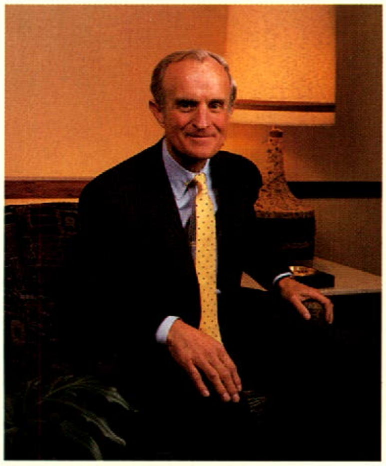
Lee M. Liberman



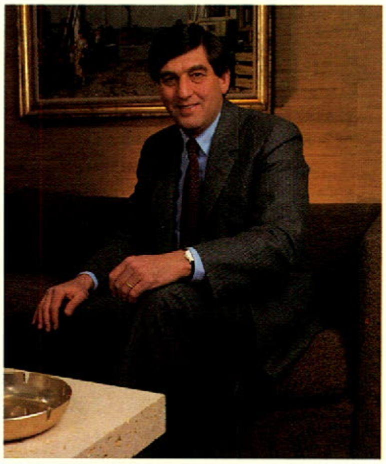
Charles J. Rothschild, Jr.



Marilyn S. Lewis



Thomas H. O'Leary



Harvey Saligman

1, 2, 3, 4, 5 **Donald E. Lasater**
Chairman of the Board and Chief Executive Officer of Mercantile Bancorporation, Inc., and Chairman of the Board of Mercantile Bank National Association

2 **Marilyn S. Lewis**
Civic leader and volunteer

5 **Lee M. Liberman**
Chairman of the Board, President and Chief Executive Officer of Laclede Gas Company

2, 3, 4, 5 **Thomas H. O'Leary**
Vice Chairman of the Board, Burlington Northern Inc.

Charles J. Rothschild, Jr.
President, Campus Sportswear Company

1, 4 **Harvey Saligman**
Chairman of the Board and Chief Executive Officer of the Company

1 Executive Committee
2 Audit Committee
3 Executive Compensation and Stock Option Committee
4 Nominating Committee
5 Finance Committee

Corporate Officers

Harvey Saligman
Chairman of the Board and Chief Executive Officer

Ronald L. Aylward
Vice Chairman of the Board

Harry M. Krogh
President and Chief Operating Officer

Eugene F. Smith
Senior Vice President, Finance

Stanley M. Cohen
Vice President

J. Carl Powers
Vice President

Charles J. Rothschild, Jr.
Vice President

Nathan S. Ancell
Vice President

Duane A. Patterson
Secretary

Robert T. Hensley, Jr.
Treasurer

Stanley F. Huck
Controller

Keith E. Mattern
General Counsel and Assistant Secretary

James K. Pendleton
Assistant Secretary

William R. Withrow
Assistant Treasurer

Russell L. Baumann
Assistant Controller

Operating Board

Harvey Saligman
Chairman of the Board and Chief Executive Officer of the Company

Ronald L. Aylward
Vice Chairman of the Board of the Company

Harry M. Krogh
President and Chief Operating Officer of the Company

Eugene F. Smith
Senior Vice President, Finance of the Company

Nathan S. Ancell
Chairman of the Board, Ethan Allen Inc.

Edwin J. Baum
President, The Biltwell Company, Inc.

Lionel Baxter
President, Big Yank Corporation

Stanley M. Cohen
Chairman of the Board, Central Hardware Company

Webster L. Cowden, Jr.
President, Cowden Manufacturing Company

Herschel Cravitz
President, Queen Casuals, Inc.

Barry S. Fine
Chairman of the Board, Fine's Men's Shops, Incorporated

Carl E. Gunter
President, Broyhill Furniture Industries, Inc.

Mark H. Lieberman
President, Londontown Corporation

Stanley Matzkin
Chairman of the Board, Devon Apparel

Bernard Mayer
President, Idaho Department Stores Co.

Ronald J. Mueller
President, The Florsheim Shoe Company

Don B. Olesen
President, International Hat Company

Carl D. Packer
Chairman of the Board, College-Town

Robert B. Peterson
Chairman of the Board, Sky City Stores, Inc.

J. Carl Powers
President, International Shoe Company

Charles J. Rothschild, Jr.
President, Campus Sportswear Company

Morton J. Schrader
President, Abe Schrader Corporation

Irving S. Wahl
Chairman of the Board, Stuffed Shirt Inc.

Shareholder Information

Transfer Agents
(Common and Preferred Stock)
Mercantile Bank
National Association
St. Louis, Missouri 63166
(314) 425-2755

Morgan Guaranty Trust Company
New York, New York 10249
(212) 587-6434

Registrars
(Common and Preferred Stock)
Centerre Trust Company
St. Louis, Missouri 63178
(314) 231-9300

Morgan Guaranty Trust Company
New York, New York 10249
(212) 587-6434

Dividend Disbursing Agent
(Common and Preferred Stock)
Mercantile Bank
National Association
St. Louis, Missouri 63166
(314) 425-2755

Independent Accountants
Peat, Marwick, Mitchell & Co.
St. Louis, Missouri 63101

Exchange Listings
Common and Preferred Shares and 14¼% Notes are listed on the New York Stock Exchange. Common Shares are also listed on the Midwest Stock Exchange. (Trading symbol: ISS)

Corporate Offices
Ten Broadway
St. Louis, Missouri 63102
(314) 231-1100
Mailing Address:
Post Office Box 8777
St. Louis, Missouri 63102

(Effective July 15, 1986)
INTERCO Corporate Tower
101 South Hanley Road
St. Louis, Missouri 63105
(314) 863-1100

Annual Meeting
The Annual Meeting of Shareholders will be held at 10 a.m., Monday, June 23, 1986, at the Marriott Pavilion Hotel, St. Louis, Missouri. Notice of the meeting and a proxy statement will be sent to shareholders in a separate mailing.

Trademarks and Trade Names
The trademarks, trade names and licensed trademarks of INTERCO and its subsidiaries, appearing in this Annual Report, are italicized.

Form 10-K Annual Report
A copy of the current Form 10-K filed with the Securities and Exchange Commission can be obtained by writing to the Treasurer of INTERCO at the Corporate Offices.

INTERCO INCORPORATED
St. Louis, Missouri